

# The Canadian Chartered Accountant

OFFICIAL ORGAN OF

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

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## Editorial Comment

### *Refresher Courses*

*The Accountant*, the official publication of the Institute of Chartered Accountants in England and Wales, tells us in recent issues of its first summer course which was held in September over a period of four days at Christ Church, Oxford. 120 members attended, 50 of them in practise, 45 in industry and 25 employed in professional firms. Lectures on various subjects were given by three senior members of the Institute and by Mr. P. F. Brundage C.P.A. (Vice-President of the American Institute of Accountants) and Mr. C. G. Renold (Chairman of the British Institute of Management). The course consisted of six groups of approximately twenty members each, which met separately for discussion after each address had been delivered to the course as a whole.

In contradistinction to the practice in North America of holding such meetings during week-days only, this course commenced on a Thursday and ended on a Monday. Saturday afternoon was taken up with golf and Saturday evening with a formal banquet. On Sunday morning, all attended church service in the Cathedral in a body.

Distances in Canada might make a gathering for such a purpose impracticable if organized as a Dominion-wide project. It could however be arranged as a provincial matter with guest speakers possibly arranged by the Dominion Association. One gathers from the reports in *The Accountant* that the atmosphere of the surroundings in which the course was held added considerably to the value of the gathering. This is a point with which this writer would heartily concur. He, himself, would suggest for Ontario a visit to Kingston during the latter part of August, the course to be held at Queen's University, golf to be played at the Cataraqui Golf Club and the harvest moon to be enjoyed from the verandah of the Kingston Yacht Club.

*My  
Ambition*

The following paragraphs are taken from an essay written under this heading by the ten-year old son of one of our members. It is not for us to comment on the first two paragraphs; we commend to all our members, however, the sentence in the third paragraph "One also gets to learn more and more as you teach". We are quite satisfied on the truth of this statement, and add that the word "write" could be a fair, but not a full, substitute for the word "teach". Many of us have the opportunity to teach; few take full advantage of it. All of us have the opportunity to write; almost none of us ever try our hand at it.

"My ambition is to be a Chartered Accountant. I like problems and most kinds of mathematics. Also my father and my grandfather were Chartered Accountants. I think I could do well in Accounting; I like it, and I think I would do some service to the world.

"A Chartered Accountant's work consists of checking businesses for the stockholders and giving advice on how to run the businesses properly. Also a Chartered Accountant is a tax expert. A man can bring in his accounts, and receipts, etc. and can leave his accounts for the accountant to study. Then the accountant is able to estimate his income tax returns. A Chartered Accountant's word is final. A Chartered Accountant's affidavit that a business is good means that the business is run the way the Accountant thinks is the best way.

"Another profession I have seriously considered is teaching. I would like to teach because I think teaching

is an interesting profession. One also gets to learn more and more as you teach. If you teach, you should never set too many essays as it wears the mind away, both of your pupils and yourself. I consider marking papers better only than writing them so a teacher must work hard to become a professor."

*'Tis not the whole* Under this heading, an adaption of  
*of Auditing to Audit* the words of James Montgomery in  
"The Issues of Life and Death"—

"'Tis not the whole of life to live;  
Nor all of death to die".

Mr. Ralph L. Stauffer C.P.A. delivered an excellent address to the Southern States Accountants' Conference held in San Antonio, Texas. We are indebted to The Texas Society of Certified Public Accountants which has reproduced it in The Texas Accountant of October 1947.

Mr. Stauffer stressed the difficulties faced by public accountants as a result of management's desire to anticipate rises or declines in prices and to take some account of them before they occur. Speaking particularly of a suggested inventory reserve against a possible decline in prices, he says:—

"There must be substance to that which becomes the subject matter for the application of generally accepted accounting principles. I ask you sincerely, how can such procedures be applied to the mental processes of an individual in a situation of this kind? There did not appear to be at March 31, 1947, nor since that date, acceptable criteria against which the creation of a reserve of this kind could be justified, measured or judged. Such a reserve seems impossible of substantiation from an auditing procedure standpoint."

As the end of a calendar year approaches, it seems to be a good time to remind all chartered accountants that their independence is their self-respect and to suggest to them that, more than ever before, pressures will be evident supporting a desire to reduce income by the creation of reserves against expected, but not actually visible, contingencies. It is generally admitted, although we in Canada do not always use the words, that we do adhere to the principle included in the American short form of report "and the results of its operations for the fiscal

year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year". Where we do not use these phrases, we must have them at least in mind and qualify reports where the presentation of the accounts does not come up to this standard.

"'Tis not the whole of auditing to audit"; the whole of auditing must include the reporting. And we might also have in mind that "'Tis not the whole of auditing to audit the accounts of the X Y Company Limited". There are a host of other clients awaiting the auditor of integrity and independence.

*Mr. F. H. Brown* Following months of uncertainty, announcement has recently been made of the resignation of Mr. F. H. Brown as Deputy Minister of National Revenue (Taxation), after almost a year in office. We wish to congratulate him on the achievements of this short period and to express to him our regret that he is unable to continue his good work. At this time of writing, no announcement has been made as to who will succeed him. We wish for Mr. Brown a speedy recovery to good health and all success for the future.



## Report of Forty-Fifth Annual Meeting

by

Thos. H. Moffet F.C.A. President

The 45th annual meeting of The Dominion Association of Chartered Accountants was held in Vancouver, British Columbia, at the Hotel Vancouver on September 8th to 12th.

The Executive Committee met on the morning of Monday, 8th September and again on Wednesday, 10th September. Council met on the afternoons of 8th, 9th and 10th September. The Committee on Education and Examinations met on the morning of Tuesday, 9th September. The general sessions were held in the morning and afternoon of the 10th September and the morning of the 12th September.

The Institute of Chartered Accountants of British Columbia provided a delightful series of entertaining events that the visitors will be happy to remember. The President of the British Columbia Institute entertained the presidents of the other institutes and their ladies at luncheon on Tuesday. At the reception that evening we had an opportunity to renew old acquaintances and to meet members whom we had not met before. The members enjoyed their luncheon on Wednesday and found the presentations and the address interesting and stimulating. On Thursday the golf players competed for the Association cup and for the several valuable trophies that were awarded that evening. Those not playing golf were taken on a cruise through Howe Sound. This was the big feature out of many big features provided for the entertainment of the members. To climax the social activities a delightful dinner dance was given in the Panorama Room of the hotel on Thursday evening.

The Association welcomed as special guests Mr. E. B. Wilcox, president of the American Institute of Accountants, Mr. Carman G. Blough, Research Director of the American Institute and Mr. A. J. J. Fanshaw\* representing the Institute of Chartered Accountants of England and Wales.

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\*Editor's Note: We record with deep regret the death of Mr. Fanshaw on October 6th. See page 302.

On Wednesday morning Mr. Blough presented an interesting and informative paper on "Recent Accounting Developments in the United States". At the luncheon on Wednesday Mr. Wilcox discussed "Some Aspects of Public Accounting in the United States". On Friday morning Mr. H. P. Herington and Mr. H. H. Adair presented papers on Accounting Requirements and Procedures in Respect to Prospectuses.

The Council on Wednesday elected the officers for the ensuing year and appointed the chairmen of the various committees. The detailed announcement in this connection appeared in the October issue of THE CANADIAN CHARTERED ACCOUNTANT and lists of the members of the various committees will appear in the Year Book.

The Council discussed, among other matters, Codes of Ethics, International Co-operation, Regulatory Legislation and the reports of the various committees. In order to implement the recommendation of the Special Committee on Ethics, which reported to the Executive Committee at its mid-year meeting, Council provided for the formation of a Committee on Uniform Codes of Ethics. This committee is to study the question of securing such uniformity, in intent as well as in exact expression, and report to the Council at its next meeting. The president explained the background for the proposal to co-operate with The American Institute of Accountants and the English Institute on certain matters of interest to the profession generally in the three countries. The president was authorized to name the delegates to attend the first meeting of the proposed joint committee in New York City early in October.

In discussing the problems arising from regulatory legislation which had been passed or was pending in the various provinces and in other countries, it appeared that, due to public opinion and other factors, more of such legislation could be expected. To assist the provincial institutes in these problems a special committee was set up, with Mr. H. C. Hayes as chairman, to review the legislation being proposed and to make recommendations to the institutes.

Council discussed at considerable length the financial situation of the Association in relation to increased costs and in relation to the plans proposed for carrying out the

functions of the Association. It was apparent that within the next two years the revenue would have to be increased by raising the dues as contemplated in the proposed amendment to by-law no. 3, by raising the subscription price of the magazine by \$1 and by increasing the revenue from advertising. In some of the institutes the amendments to their own by-laws to provide a larger payment to the association become effective only from June 1, 1948. For this reason, while Council agreed that the subscription price of the magazine should be increased by \$1 as from June 1, 1947, it recommended unanimously that the increase in the amount of dues per member be made effective as from June 1, 1948. The annual meeting of the Association approved the recommendation of Council.

At its meeting on Tuesday, 9th September, the Committee on Education and Examinations decided that, starting with the 1947 examinations, candidates' standings will be reported by grades rather than by marks, and that starting with the 1948 examinations, the content of the Final Accounting III paper will be altered to cover the Dominion Companies Act, the Dominion Income Tax Act and other laws of Dominion-wide application. The subjects presently covered in this paper will be covered in the general paper, Final Accounting IV.

Acting on a recommendation from the Ontario Institute, this committee provided for setting up a special committee "to study the educational requirements, standards and methods for qualifying and generally training Chartered Accountants". It is expected that this will be one of the most important studies undertaken by the Association and that its results will have far reaching effects upon the profession.

The reports printed in the Year Book and which will be issued from time to time will give further information regarding the numerous other matters that were discussed by the various committees and by Council.

## Trends in Post-War Tax Policy

by J. G. Glasco, F.C.A.

**I**N accepting your invitation to come to Chicago to talk about taxation I am aware that I am touching controversial ground in your country as well as in my own. As a Canadian, however, I am very happy to have this opportunity because we have a common interest in the solution of problems which are similar in both countries.

The principal problem, briefly stated, is that due to the costs of the war and increased social security measures, revenue requirements in both Canada and the United States are about three times the pre-war figures. To support this increase both countries will require national income of approximately double the pre-war volume. Unless our tax structure is sound, it will fail to provide the revenues required—or, what is even more serious, it may, in the process of raising such monies, impair or destroy important sources contributing to our national income. Whether we like it or not, both Canada and the United States stand committed to a scale of government expenditure which can only be supported by a broad and sustained increase in their revenue bases.

While, therefore, our positions are very similar, I should point out one important difference. If we in Canada should not succeed in working out our problems successfully, the economy of the United States would not be seriously affected, but, if you should not succeed in this purpose, the consequences for Canada would be very serious indeed. This is because we depend upon our export trade to the extent of about 40% of our national income whereas a comparable figure for the United States is about 7%. We are, therefore, directly affected by any development which reduces our exports to you and indirectly, but no less certainly, by any disturbance of your trade with our other customers, particularly the United Kingdom. Our prosperity is geared immediately to yours and when we wish you good luck in the solution of your problems we are about as disinterested as the farmer's wife with a lot of small children who wishes her husband good luck with the crops.

\* Address given at a luncheon of the Insurance Accounting and Statistical Association in Chicago on 17th May 1947.

I am told that over three thousand post-war tax plans have reached Washington and I would like to assure you at once that I do not propose to present another plan here today, nor will I attempt any predictions as to what policies may emerge from the study and discussion of these plans by your Government and mine. I would like also to disclaim any right to speak to you as an expert. The views which I put forward are those of an ordinary citizen. I am only anxious that the right answers should be found and that they should be supported by well-informed public opinion.

What is going to happen taxwise during the next 2 or 3 years? The first thing that strikes me is the serious possibility that no positive and comprehensive tax policy may emerge at all. There is, I think, danger that in spite of all the proposals which are being put forward, and perhaps partly because of their number and variety, we may achieve nothing more than confused compromises. If that happens we may again look for the old familiar patchwork procedure, whereby our laws are changed each year to meet current political and short-term economic demands.

A quick look at recent tax legislation and budget procedure in different parts of the world suggests that this process is indeed setting in, and, in particular, that personal initiative and risk-taking by private capital are not receiving much encouragement. The goose that lays the golden egg, while not yet shot down, appears to be encountering heavy anti-aircraft fire!

An extreme example of this is found in the first budget presented to the Central India Legislature: under this, corporation taxes are doubled, a special 25% tax on business profits is imposed and capital gains are taxed for the first time: along with this is the removal of the salt tax which has for so long engaged the attention of Mr. Ghandi.

The recent English budget contains measures which will clearly discourage new corporate financing and which seem designed to strengthen the Treasury's control over new-capital markets. In Canada, the removal of the Excess Profits Tax has been deferred until the end of 1947, possibly because the large business profits currently realized render immediate relief politically unpopular. There is some comfort, however, in recent statements by your Secretary of the Treasury, Mr. Snyder, and by our Minister

of Finance that active consideration is being given to the tax structure as a whole. Mr. Snyder in his recent statement to the Senate Finance Committee stated:

"In anticipation of later tax reductions we should review the whole tax system. We should re-examine not only the individual income tax but also the corporation income tax, excise taxes and estate and gift taxes. Such a comprehensive review should aim at revision that will fit all major taxes together into a system that will produce adequate revenue, will be fair and equitable, will interfere as little as possible with incentive to work and invest and will help maintain mass markets for mass products."

Let us agree that any sound tax policy will have to recognize squarely the need for much higher returns than we have ever been accustomed to in peace-time, and it must deal with the productive system as a highly intricate going concern whose motive power has to be maintained and increased. Is a policy which combines these features going to win general approval and support? I am afraid it may not. In the first place, people do not easily accept proposals implying that their taxes must continue to be unpleasantly high: secondly, the public has come to view taxation as a highly technical and difficult business, in which the taxpayer has a full-time job in understanding his own position without worrying about other people's problems, also there is a natural tendency to judge such questions according to political sympathies or suspicions, rather than in the light of evidence which requires some effort to examine. If, for these reasons, our tax policy should be stalled by the cumulative effect of negative decisions, we shall be indeed in a desperate condition.

I mention this as our first problem because I don't believe we can afford to drift. Sooner or later the public must come to realize that we on this continent cannot expect to go through the most destructive war in history and come out of it unscathed; but the fact is that the impact of the war upon our economic system has not yet become evident to the man on the street. Taxation, even at recent peak rates, has not damaged our economic system as a whole because the pressure has been more than offset by the inflationary force of government expenditure. Business management has had to deal with immediate problems of

supply and delivery, rather than wrestle with the long-term problems of market development and low cost production. For the time being, the process of reconversion has been carried along on a flood tide of deferred demand, spreading out in a record volume of purchasing power. We all know that this state of affairs is not permanent but while it lasts it encourages the belief that if a comfortable measure of tax relief is distributed all round now, a more critical examination of the tax system can be postponed.

I am sure that you gentlemen do not share this complacent view and the volume of writing and discussion upon the subject makes it clear that business and professional men in responsible positions are seriously concerned. Unfortunately there is little evidence that any realization of the dangers of drifting has really penetrated public opinion.

What can usefully be done about it? Surely the essential object is to bring public opinion to a point where it views taxation as a prime factor in the movement of the economic system—something whose effects can be observed in the same way as are the effects of rainfall or erosion and controlled accordingly. This is in contrast to the customary view of the subject which has hitherto been confined to the year-end accounts of the government and the taxpayer, the operations of the productive system being taken largely for granted. In your dust bowl and on our prairies we have seen the consequences of taking soil fertility too much for granted.

I think that two things at least can be done. Government itself has the first responsibility. The fact that the amounts raised by taxation, and the methods used, and the way the proceeds are spent, have important indirect consequences, is already acknowledged by government authorities. These consequences should be explained to the public as explicitly as possible. If they are known or predictable, any democratic government should be prepared to tell the people what they are. If they are not known, the government would be under some obligation to find out, and if the government cannot find out, others would perhaps be encouraged to do so. As Thomas Jefferson explained to George III, the whole art of government consists in the art of being honest.

This suggestion is not as original as it may seem. In Canada during the war the intended effects of the tax



programme were explained in Parliament as each stage developed, and there is no doubt that public opinion responded with better understanding as a result. In this country, the appointment of the Council of Economic Advisers under the Employment Act of 1946 to report to the President who in turn presents an Economic Report to Congress, makes official provision for procedure such as I am suggesting. In the United Kingdom, the appearance of the government's economic survey has become an established feature of preparation for the budget. This sort of frankness should be extended with particular reference to the effects of taxation. The government should publish information showing the distribution and incidence of the overall tax burden. In this way the public itself can see the various revenue sources and find out whether the tax burden is in fact distributed as it is supposed to be. On the basis of such information, it should be possible to judge the soundness of any given line of policy—for the first time a means of checking the results would be available.

I admit that this suggestion is a little like asking the government to stop playing Russian pool and proceed to call its shots, but I do believe that this practice will in the long run be of great assistance to the government itself. It is admitted that many questions would remain unanswered because the information would necessarily be condensed and generalized. In spite of that, this practice would contribute more than anything else to well-informed discussion of taxation and fiscal policy. It would give us our bearings and would help us check our course. In the period which we shall enter, when the present exceptional stimuli have spent their force, the general shape and balance of the tax structure will be all-important.

The second contribution should come, and is coming to some extent, from people like ourselves—from lawyers and accountants who see a large variety of particular problems in the course of their work, and from corporation executives who have to deal with them as they arise in their own companies. The approach from this side will naturally be principally concerned with adjustment and refinement of methods, but even purely technical tax problems lead back to broader considerations of policy and sometimes put them in a new light. In this country the Senate Finance Committee provides a valuable forum for public dis-



cussion of tax policy, and it is encouraging to note that your business leaders are standing up and saying what they think in no uncertain terms. As an example, the recent statement to that committee by Mr. E. M. Voorhees, Chairman of the Finance Committee of the U.S. Steel Corporation, was a bold and challenging argument upon a vital aspect of your tax system.

However, critical activity of this kind will only carry us so far unless the results are brought together and crystallized. Professional associations can accomplish useful work in this direction, but the general public is barely aware of their existence. To ensure the best results, two further things are necessary, namely, public discussion in which opposite points of view can be brought together and, in addition, a careful testing of generalized opinion through analysis and reasoned estimate of facts. There is wide scope for research in this field and it is encouraging to see how far it is being cultivated in some of the post-graduate schools of your universities. It is for the reasons just mentioned that the two associations which represent the legal and accounting professions in Canada have sponsored the organization of the Canadian Tax Foundation. That organization is now getting started on lines which have been followed successfully by similar research bodies in the United States.

Up to this point I have attempted to explain what I conceive to be the dangers of inertia and the real difficulties which must be overcome in evolving a sound taxation policy. I have suggested that our first need is a proper concept by the public of the importance of our tax structure in our economy: I have suggested that two ways of bringing this about are for the government to take the public more completely into its confidence and for the people of the country, individually, through their professional service, and trade associations, and by supporting research, to promote well-informed public discussion of tax policy and fiscal policy generally.

If the various influences which we have been considering can work together to produce a coherent policy—perhaps it would be better to say philosophy—of taxation, which will have the broad support of public opinion, what are its principal elements likely to be? As I have promised not to produce any plans or prophecies, I shall simply

review the main questions which should be taken into account, as I see them.

The first question is the level of rates. Hitherto, under our system of making an annual review of the national accounts, and because a large proportion of government expenditure is inflexible, tax rates have generally been increased in periods of depression and reduced when times were prosperous. Taxpayers have thus had their incomes squeezed when they were already shrinking and relieved when they expanded. It seems now to be generally agreed that this is thoroughly unsound and that in the past it has accentuated the swings and effects of the business cycle.

In future, therefore, we should look for a more realistic recognition that the volume of production and the general level of incomes are the chief factors influencing the proceeds of taxation. This means, in effect, the application of the principle of a tithe to a variable crop, under which the rate structure would be drawn with a view to its yield over a period of years, rather than adjusted annually in an attempt to stabilize the yield. This principle, which incidentally was recognized in the budget speech of the Canadian Minister of Finance two weeks ago, has some important immediate consequences. Now that the extreme tax levels, deliberately imposed for war purposes, have been modified to the extent absolutely required by public opinion, there may remain very little room for further general reduction—if we are serious about balancing budgets and reducing debts while the going is good. Any further reductions in one sector will have to be compensated by increases in another, and the total proceeds will in any event fall significantly when boom conditions subside. While continued reduction of tax rates may not, therefore, be expected over the next two or three years, it will be possible in the long run, but only to the extent that dynamic economic progress can be resumed, to produce permanently higher levels of production and income which will increase the tax potential. The important point is that the achievement of this object will depend, among other things, upon whether the general design and operation of the tax structure itself will be such as to permit it. If revenue requirements are to run at three times pre-war levels, the damage which ill-devised tax expedients will do needs no emphasis.

It will be interesting to consider for a moment, there-

fore, those features of the tax system which appear most seriously to affect the prospects of long-term expansion.

In the various plans produced in this country, so far as I am acquainted with them, two schools of thought can be distinguished. One is principally concerned with the maintenance of the spending power of consumers and the effects of taxes upon mass consumption. The other is mainly concerned with encouragement of investment and the effects of taxes upon capital accumulation and risk-taking. There is nothing incompatible between these views but in the face of our present revenue requirements it is virtually impossible to devise a tax method completely acceptable to both schools of thought. It is really a choice of the lesser evil. It may well be that if we are to restore incentives we shall have to face some dilution of mass purchasing power by indirect taxation.

The emphasis upon maintaining consumption expenditure may be relevant in the near future to a tax policy designed to prevent the present boom from tailing off into a steep decline. That is important, but is a very short-term objective. I suggest, however, that it will not meet the problem of encouraging resumption of long-term expansion. Let us see where the alternative leads us.

The deterrent effects of certain taxation upon risk-taking and capital investment have been discussed repeatedly from the standpoint of business incentive. It is a self-evident proposition which requires no repetition here. But, it may go further than a question of incentive. It might be possible to preserve a considerable degree of incentive while, at the same time, the effects of taxation were wearing down and slowing up the economy in other ways; and such a process of attrition might only become apparent over a fairly long period.

Clumsy or excessive taxation of business concerns, as distinct from the direct taxation of their shareholders, can, I believe, easily result in progressive decay of the process of internal financing without appreciation of the damage until it has been done. Thus, the ability of business to earn satisfactory profits over the short term may conceal long-term deterioration of efficiency; the symptoms are a lag in replacement of obsolescent plant, stagnation of top-heavy capital structures, and high mortality of small inde-

pendent new concerns which go out of business before they can get their roots down.

It is no answer to say, as some people do, that when a business needs additional capital it can always get it by cutting dividends. Certainly, in some cases this will work, but in the ordinary run of business, capital will not be forthcoming at all on such terms. For the future we must recognize the necessity of a sustained new growth of small enterprises if our industrial system, like a forest, is to maintain its health and vigour. Further, we should realize that, particularly in the early life of new businesses, there must be retained earnings to reinforce equity capital, repay debt and carry out expansion and improvements to plant, of which improved working conditions is often the first requirement. We need to encourage an open as well as a free enterprise system.

The kind of expanding economy which will permit us to take prospective taxes in our stride and, it is hoped, retire some debt as we go along, will require extension of production at the lowest unit costs. For the United States it is a matter of exploiting your tremendous domestic market; for us in Canada it is a matter of maintaining our foreign trade. For both of us it is a matter of supporting high real wages. We may expect that obsolescence will develop more rapidly than we have been accustomed to reckon it in peace-time in the past. This certainly should be so if the new methods and materials which we have learned to use during the War can be applied to civilian needs energetically and resourcefully. Therefore, any influence which obstructs or discourages renewal or extension of plant is positively destructive. Further, we might just as well recognize that labour costs will be higher and more rigid than in the past. This not only increases the need for utmost efficiency and flexibility in methods of production, but points to the difficulties inherent in fixed charges arising from excessive or frozen funded debt. From every point of view we can see the need of a real growth in equity capital; and we can visualize the damage which the economy as a whole can experience either from excessive rates of taxation of corporations, as such, or from misguided application of outdated provisions and methods of administration of the tax law.

If these dangers are recognized and avoided the result

could well be an impressive refutation of the "mature or stagnant economy" thesis. There may be no new geographical frontiers to open, but the opportunities for intensive cultivation of our existing knowledge and resources are unlimited. It is widely believed that the central point of instability of business conditions is to be found in the fluctuations in demand for the products of the great capital goods industries. The customers of these industries are the manufacturing and service industries, small and large, whose plans collectively determine this demand. If, therefore, we can ensure the widest freedom and resourcefulness of this second class of producers, which represent the bulk and also the diffusion of the nation's business, we probably have the main key to the sustained expansion we are looking for.

If this discussion seems to have led some way from the subject of taxes it is because methods of taxation, in the light of our revenue requirements, may very well prove to be the decisive factor affecting our ability to carry the load. If the problem is tackled in the right order of ensuring a big crop before it is divided up, there can be generous shares for everyone. But if we simply take our productive resources for granted they will not remain unchanged. They may gradually dry up at the source and we shall not see what is happening until it is too late to stop it.

Because its effects are more clearly visible, nothing has been said about personal income tax, although it is and will probably remain the principal pillar of the whole tax structure. Being felt directly by all concerned, the application of this tax will always be conditioned by the attitude of the whole body of taxpayers, whose political representatives can be counted on to represent their views.

But the corporation income tax is in a different category. Although it is sometimes classified as a direct tax it is, of course, no such thing: it falls indiscriminately upon the persons who ultimately share the burden, whoever they may be. Anyone would hesitate to advocate the deliberate double taxation on a random basis of individuals who have the enterprise to back their business judgment with their money. But many continue to believe that a method of doing business possesses, as such, some independent capacity for paying taxes quite impersonally, and the illusion will die hard. We must therefore assume that corporation

taxes will remain, possibly at relatively high rates in the near future, and permanently in some form because of the convenience of collection. It is therefore all the more important that their possible consequences should be understood and controlled.

I have ventured to discuss with you in some detail the whole question of cultivating a wide and well-informed understanding of the problem of taxation because the members of your Association are particularly well placed to give valuable leadership and guidance. By reason of your professional training you can see and analyze consequences of tax policy which escape the attention of the majority; and by reason of your position in the insurance business you have an important stake in our economic system from the long-term standpoint of the institutional investor.

At this immediate stage of affairs I think it is perhaps more important to clear the air of misconceptions and to see the direction we should go, than to look at once for the adoption of this or that carefully devised scheme of taxation on which opinions are bound to differ and for which public opinion is unprepared. The confidence of the people, which is the real foundation of any constructive treatment of the matter, depends upon knowledge of facts on which it is possible to agree, and upon a feeling of assurance that any policy will be guided by this knowledge. The greatest danger is confusion of purpose.

When the recent Canadian budget was introduced the Minister of Finance referred to the first such occasion seventy-nine years ago when his predecessor of that day, in the course of a four hour long speech presenting a budget of 14½ million dollars, defended the government from the charge that the country was groaning under a heavy load of debt and taxation. Those groans sound like a sigh of contentment today. However, we simply cannot afford to assume that economic progress will continue automatically to solve our present problems in due course. Careful thought and management are necessary if we are to secure the conditions in which such progress can be resumed. With these, it is even possible that we may see fulfillment of a recent prediction that the present boom could collapse into prosperity.

## Prospectuses

*A paper substantially prepared by W. L. McDonald, F.C.A., and read by H. P. Herington, F.C.A., at the second general session of the Annual meeting in Vancouver on September 12, 1947.*

**I**T IS with mixed feelings that I appear before you this morning. It is to me a matter of regret that Mr. McDonald was unable to come to Vancouver and present the paper which he has prepared. I know it has been a great disappointment both to him and to Mrs. McDonald to have missed this opportunity of visiting Vancouver and joining you in the activities of the week. I will not attempt to disguise the fact that whatever regrets there may be are in no small measure tempered by the good fortune which has fallen to me.

Mr. Chairman, you have asked me to read Mr. McDonald's paper. By way of introduction, if I may I should like to give you a brief report on what the Ontario Institute has done during the past year in an effort to improve the standards of the practising accountants insofar as their work on prospectuses was concerned. Early in the year, Col. H. D. L. Gordon suggested to me that, as President of the Ontario Institute, I should form a committee to study current practice in this regard as revealed by the many offering circulars which were appearing from time to time and to prepare a memorandum as a guide to the members of the Institute in connection with their work on prospectuses. I readily accepted the suggestion and a committee was formed under the chairmanship of Col. Gordon. The Committee in due course issued its report and it is interesting to note that the Securities Commission of Ontario, to whom a copy of the memorandum had been sent, reproduced the report in a memorandum issued as a guide to underwriters and others concerned with the preparation of prospectuses. The Commission has been most appreciative of the help the Institute in Ontario has given to them in connection with the administration of the Securities Act, and I believe that the Commission will continue to look to us for guidance in matters pertaining to accounts.

Mr. McDonald's paper, which I will now read, deals entirely with the law. When I have concluded the reading I intend to take the liberty of adding some thoughts



of my own in regard to the accounting principles applicable to prospectuses.

The Securities Act, 1945, of the Province of Ontario makes provision for setting up a Commission composed of a chairman and not more than two other members. The staff of the Commission includes a registrar and such other officers, clerks, etc. as may be appointed. No person or company may trade in any security unless he or it is registered as a broker or salesman of a registered broker. However, registration is not required in respect of certain classes of trades and securities. Provision is made whereby the Commission may carry out investigations of the affairs of any person or company where it appears probable to the Commission that such person or company has violated any of the provisions of the Act or the regulations or has committed an offence under the Criminal Code in connection with a trade in securities. Where this is confirmed by the investigation the results are to be reported to the Attorney-General. Provision is also made whereby the Attorney-General may order an investigation into any matter relating to a trade in security.

No stock exchange may carry on business without the consent in writing of the Commission. The executive committee of every stock exchange must employ an exchange auditor and provision is made for the selection of a panel of accountants and the audit of the accounts of members of the stock exchange by an accountant whose name appears on the panel. Provision is also made for the audit of the accounts of brokers and security issuers who are not members of a stock exchange.

These provisions are of interest to residents of Ontario but are not enlarged on in this discussion because they do not concern the public accountant resident in other provinces. However, in a great many cases, the public accountant, no matter where located, finds that he must have some knowledge of the Ontario Securities Act in connection with the issue to the public of the securities of a company of which he is the auditor and the purpose here is to review the requirements of the Act and the regulations in such a case.

Section 49 of The Securities Act 1945 provides that "No broker or salesman shall trade in any security either



on his own account or on behalf of a person or company where such trade would be in the course of a primary distribution to the public of the security until:

- (a) A clear and concise statement in the form prescribed by the regulations dated and signed by every person who is, at the time of the filing, a director or promoter of the person or company issuing the security or an underwriter or optionee of the security, containing a full, true and plain disclosure of all material facts including details of all options and any other information that may be prescribed by the regulations has been filed with the Commission and a written receipt therefor received from the registrar; and
- (b) Such broker, or in the case of a salesman, the broker by whom he is employed, has notified the Commission in writing of his intention to engage in such primary distribution to the public."

Pursuant to the provisions of this subsection of the Act, regulations have been adopted setting out the nature of the information required to be filed when there is a primary distribution to the public. Form 5 is the form prescribed for a Mining Company. Form 6 is to be used in the case of a "Natural Gas or Oil Company", and in the case of all other companies the requirements are Form 7, or any other form which includes the information required by Form 7 notwithstanding that it may also include other material.

The information required by Form 7 is substantially the same as that which is required in a prospectus prepared in compliance with the Dominion Companies Act which is usually referred to as the statutory information. This statutory information is not primarily the responsibility of the accountant and I do not propose to take up your time by dealing with it in detail.

In the case of a mining company a full and up-to-date report on the property by a qualified mining engineer, geologist or prospector is also required.

It is subsection 4 of Section 49 which is of particular interest to the accountant. This provides that "In the case of a company which has been carrying on business for more than one year prior to the date of the statement, a balance sheet and profit and loss statement of the company, or if the company has any subsidiaries,

unless the Commission otherwise directs, a consolidated balance sheet and profit and loss statement of the company and all its subsidiaries, certified by the company's auditors, as at the end of the last completed financial year of the company or as at a date not more than one hundred and twenty days prior to the date of the statement, whichever is the later date, or at such other date as the Commission may approve where the Commission is satisfied that a balance sheet and profit and loss statement or a consolidated balance sheet and profit and loss statement, as the case may be, as at such date fairly represents the financial position of the company or the company and its subsidiaries, as the case may be, at the date of such approval, shall accompany the statement under subsection 1", i.e. the statutory information.

Subsection 6 provides that "where a change occurs during the period of primary distribution to the public in any material fact contained in any statement, balance sheet, profit and loss statement or report filed under this section, which is of such a nature as to render such statement, balance sheet, profit and loss statement, or report misleading, a new or correcting statement, balance sheet, profit and loss statement or report shall be filed within twenty days from the date such change occurs . . . ."

Subsection 7 exempts certain sales of securities such as government securities, the sale by a company exclusively to the holders of its securities of additional securities where no commission or other remuneration is paid, listed securities and securities traded or sold to the public except in the primary distribution to the public.

Section 50 gives the Commission the right to determine whether the proposed or intended trade would be in the course of the primary distribution to the public of the security and to rule accordingly and such ruling shall not be subject to appeal.

The Commission may accept for filing any statement submitted for filing under Section 49 and direct the registrar to issue a receipt therefor unless it appears to the Commission that—

- (a) The statement or any balance sheet, profit and loss statement or report which is required to accompany the statement—
  - (i) fails to comply in any substantial respect with any of the requirements of Section 49,

- (ii) contains any statement, promise or forecast which is misleading, false or deceptive; or
- (iii) has the effect of concealing material facts.
- (b) An unconscionable consideration has been paid or given or is intended to be paid or given,
  - (i) for promotional purposes; or
  - (ii) for the acquisition of property, or
- (c) The proceeds from the sale of the securities which are to be paid into the treasury of the company, together with other resources of the company, are insufficient to accomplish the objects indicated in the statement;  
or such escrow or pooling agreement as the Commission deems necessary or advisable with respect to securities issued for a consideration other than cash has not been entered into."

As no trading in the course of primary distribution to the public may occur until the statements referred to in Section 49 have been filed and a receipt issued therefor it can be seen that unless the statements comply with the requirements of Section 49 the relative securities cannot be sold in Ontario.

The financial statements required by subsection 4 of Section 49 are the ones that primarily concern the public accountant as they must be certified by the company's auditors. These financial statements are to be filed in the case of a company which has been carrying on business for more than one year and are to include a balance sheet and profit and loss statement or if the company has subsidiaries a consolidated balance sheet and profit and loss statement of the company and all its subsidiaries, unless the Commission otherwise directs.

These financial statements are to be as at a date not more than one hundred and twenty days prior to the date of the statement filed with the Commission pursuant to the provisions of subsection (1) of Section 49 i.e. the statutory information or at the end of the last completed financial year of the company whichever is the later date or at such other date as the Commission may approve. However, the Commission may not approve any other date unless the financial statements as at such date fairly represent the financial position of the company at the date of such approval.

Possibly the most practical method of considering the Ontario requirements is to compare them with the requirements of the Dominion Act. In accordance with the allocation of authority under the British North America Act, the Dominion Companies Act legislates in respect of companies with Dominion Charters and the Ontario Securities Act regulates brokers' trading in Ontario. However, the requirements with respect to financial statements are very similar and usually no great difficulty is involved in preparing financial statements for a prospectus which will comply with both acts.

In the case of a company which has been carrying on business for more than a year the Dominion Act requires a balance sheet or if the company has subsidiaries a consolidated balance sheet. This is the same requirement as that of the Ontario Securities Act. However, in the case of the Ontario Securities Act if the company has subsidiaries a consolidated balance sheet need not be filed if the Commission otherwise directs. Where the equity capital owned by the parent is small in relation to the subsidiary's funded debt and properties, and where the parent is issuing bonds on its own properties a consolidated balance sheet might be entirely unsuited for the purpose. The requirement that in all cases where there are subsidiaries a consolidated balance sheet shall be filed is considered a defect in the Dominion Act but presumably, when such a statement might operate to mislead the prospective investor, application could be made to the Provincial Chief Justice to obtain an order permitting the use of unconsolidated or partly consolidated statements. The usual practice is that the Provincial authorities require the same information as would be presented to the Chief Justice before issuing a direction that unconsolidated statements can be used.

It should, however, be noted under both acts that a balance sheet is required and if a pro-forma balance sheet is given it is in the nature of additional information.

The requirements as to dates of financial statements are the same in both acts. In the case of the Dominion Act the Provincial Chief Justice may allow the use of statements more than one hundred and twenty days old and in the case of the Ontario Act the Commission, if it is satisfied that the financial statements at such other date fairly

represent the financial position of the company, may approve the use of some other date. In practice, if a supreme court justice allowed statements as of a date more than one hundred and twenty days prior to the date of the prospectus to be used, The Ontario Securities Commission would probably accept such statements but would probably require a letter from the company's auditors to the effect that there had been no material adverse developments in the company's financial position between the date of the financial statements and the filing of the prospectus.

It is, however, in the matter of the profit and loss information that The Securities Act is somewhat indefinite. The Dominion Act requires where applicable "a report by the auditors of the company with respect to the profits of the company and the nature and source thereof, or the losses of the company, as the case may be, in respect of the last completed financial year of the company and of the two preceding financial years, year by year", such statement to be consolidated if there are subsidiaries. The Ontario Act requires simply a profit and loss statement of the company and if the company has subsidiaries a consolidated profit and loss statement unless the Commission otherwise directs.

From this section one might infer that a statement of profit and loss for the last fiscal year of the company or even for the portion of the fiscal year ending on the balance sheet date might be required. However, in practice this requirement has been interpreted to correspond to the report of the auditors on the earnings and sources thereof required by the Dominion Act.

The Commission has prepared a document entitled "Notes re financial statements as required under Section 49 of The Securities Act, 1945". These notes are not regulations made by the Commission pursuant to the provisions of the Act but are indicative of what the Commission will require before it accepts the financial statements.

The preamble to the notes reads as follows:

"When examining prospectuses for bond and share issues submitted to this Commission for approval, we are primarily concerned in seeing that the submissions are in accordance with the requirements of The Securities Act, 1945, and that a full, true and plain dis-

closure of the facts is given to the public. The financial statements, prepared by the auditors of the companies concerned, form a very important section of the prospectus because of the information thus made available to the prospective purchasers and also because figures based on the financial statements are invariably quoted in other parts of the prospectus.

"Sections of The Securities Act, 1945, and the various Companies Acts, deal with prospectuses and set out the minimum requirements but it is considered essential that additional relevant information be included therein, and certain procedures be followed by the auditor when preparing the financial statements and other information used in the prospectuses. It must be remembered that this circular is not intended to stipulate the maximum requirements or to set a limit on the information to be supplied by the auditor and we shall expect a full disclosure of all pertinent information which in the public interest should be included in the prospectus.

"The additional information required and the procedures which we assume will be followed by the auditors, are listed herewith."

The requirements set out in the first part of the notes conform closely to those set out in Bulletin No. 2 of the Committee on Accounting and Auditing Research. Under the heading *Prospectus* in the Notes appears the same requirement as in the Bulletin to the effect that the auditor should review the entire circular before it is finally printed to satisfy himself that, within his knowledge, the contents are correct and not misleading and that unless given such an opportunity the auditor should not permit the use of his opinion in the prospectus. This requirement is considered to be of extreme importance and should be adhered to in all cases.

Under the heading *Statement of Earnings* in the Notes the requirement as to term is the same as that in the Bulletin, i.e. that the statement of earnings should be for a sufficient number of years to give a reasonable picture of the operations of the business and because of the abnormal circumstances of the war years should not be confined to the legal requirements of three years under the Dominion Companies Act. In the Bulletin it is stated

that this three-year period is usually now not of sufficient length because of war conditions. The Notes state that "Care should be taken that the earnings statement does not emphasize the earnings of war years". Incidentally this problem of the period for which earnings should be shown has been the subject of a considerable amount of discussion among public accountants. The majority of the profession seems to feel that a longer period than three years should be a statutory requirement. However, when one realizes that the prospective investor is only interested in past earnings to the extent that they furnish some criterion as to what future earnings may be, it is readily apparent that in some cases, where there has been a substantial change in the nature of the business, the earnings of the period prior to the change may be misleading. It is therefore my opinion that the statutory requirements should not go beyond the present minimum of three years and that the furnishing of information for a longer period than this should be left to the judgment of the persons concerned subject to the requirement in the Bulletin that it should be for a sufficient number of years to give a reasonable picture of the operations of the business.

The Notes then repeat the requirement of the Bulletin that the statement of earnings should incorporate, in the year affected, any adjustments which have subsequently been made through surplus or profit and loss account. This, of course, simply means that, in preparing the statement of earnings for the prospectus, prior year surplus adjustments should be allocated to the earnings of the year to which they apply.

The Notes then state that "In all instances the statement of earnings should show the net income, depreciation provided, interest paid on bonds or debentures, provision for taxes on income and the net profit or loss for each year". This requirement is the one important difference between the Bulletin and the Notes. In preparing its Bulletins the Committee on Accounting and Auditing Research must take into account current practice because unless it does so it will forfeit the support without which its Bulletins would be of little effect. Therefore the Committee differentiated between the requirements in the case of stock and share issues and those in the case of bond and debenture issues. The requirements of the Bulletin



in the former case correspond with those of the Notes, but in the latter case the Bulletin recognizes current practice and does not suggest as a requirement that interest on other than senior issues or provisions for taxes on income be shown. However, the Bulletin states that the Committee considers it desirable that the statements also show interest on other bonds or debentures and provision for taxes on income.

The Notes include the statement in the Bulletin to the effect that "A statement of earnings is a historical statement. Changes in the figures to reflect changes or expected savings are dangerous, in that not all changed conditions are being reflected, whereas in fact the economic conditions existing during the period of the earnings statement may be entirely different from those prevailing today. To attribute to a former period certain conditions presently existing, and at the same time to ignore other changed conditions, is likely to be misleading. For this reason such adjustments to earnings should ordinarily be avoided". The Notes stop at this point but the Bulletin continues ". . . but if used, the statements should set out clearly all such adjustments which have been made".

Because statements of earnings in a prospectus are given in order to furnish the prospective investor with some criterion of future earnings, it is often asserted that they should be adjusted with this purpose in mind. For instance, if a 6% bond issue is being replaced by a 3% bond issue, it is suggested that the interest charge in the earnings statement should be adjusted to the 3% basis. However, at some time during the period covered by the earnings statement, the 6% rate probably represented the going cost of money and the gross profit margin in competitive businesses was based on such an interest cost. With the reduction in the cost of money, there would probably be a reduction in gross profit rates and to deduct from the profits earned when money cost 6% the bond interest, at a 3% rate, is considered to be an unwarranted and possibly misleading adjustment. Similarly the war conditions which gave rise to high taxes on earnings also gave rise to high gross profits. To apply to the profits of the war years tax at 1947 or 1948 rates is also considered misleading because with the hoped for return to normal business conditions there will probably be a decline in



gross profits as well as a decline in rates of taxes on earnings.

However, the accountant cannot close his eyes to the purpose to which the statement of earnings is to be put and there are certain adjustments which should be made. For instance, if an extremely profitable department of the business has been sold recently and the proceeds used to retire preferred shares, the historical statement of earnings would hardly be suitable for use by a prospective investor. Similarly, if a company has sold all its investments to pay a dividend under Part XVIII of the Income Tax Act, it would probably be necessary to eliminate the income from such investments from the statement of earnings and to adjust the provisions for taxes on earnings correspondingly. For this reason the Bulletin recognized that in some cases such adjustments are necessary.

The Notes contain the same statement as the Bulletin to the effect that the use of average figures for a period of years, without disclosing the annual figures from which the averages were computed, is considered misleading.

The requirements as to the auditor's report itself in the Notes is much the same as in the Bulletin. The Notes state that "The auditor's report which must (the Bulletin says should) be printed in full *should* contain an expression of opinion and not merely refer to the fact that the statements have been prepared or examined by him. The auditor should not express an opinion if it is so qualified as to be useless to an investor and, in addition, should not express an opinion unless he has made sufficient examination to warrant its expression. The auditor's certificate, whether it be placed at the foot of the balance sheet or incorporated in his report, must comply with the requirements of the Companies Act under which the company was incorporated."

As the next paragraph in the Bulletin is directed to the practising accountant and deals with the acceptance of the work of other members of the profession, it naturally is not included in the Notes.

The requirements of the Notes with respect to pro forma statements which are similar to those set out in the Bulletin read as follows:

"If a pro forma statement is issued it is important that it be clearly labelled as such and that complete

disclosure be made of the underlying assumptions on which the statement is predicated. An opinion should not be expressed on a pro forma balance sheet, unless there are firm commitments from responsible parties and reasonable assurance that the company's position will, in fact, resemble that shown by the statement".

With respect to balance sheets, the Bulletin suggests that they should meet the requirements of the applicable companies acts, but also those of the "Statement of Standards of Disclosure" issued as Bulletin No. 1 of the Committee on Accounting and Auditing Research. The Notes read as follows with respect to the balance sheet:

"The balance sheet prepared for inclusion in a prospectus must meet the requirements of the Companies Act under which the company was incorporated and the requirements of Section 49 (4) of the Securities Act 1945.

"The following is a listing of minimum standards of disclosure in balance sheets and related statements but they are not to be construed as being sufficient, if additional disclosure is necessary to prevent pertinent information being withheld from the prospective investor or where a financial statement otherwise would be misleading."

The Notes then repeat in substantially the same form the requirements set out in Bulletin No. 1 with the following differences:

1. Under Investments in Affiliated Companies the suggestion in the Bulletin that "In certain instances the financial statements of the individual subsidiaries should also be submitted to the shareholders of the parent company" is not included in the Notes.
2. The Notes omit the statement made in the Bulletin that "Prepaid expenses may be classified as current assets".
3. The Notes omit the requirement that "Any increase in shares outstanding during the year should be set forth and the consideration received therefor should be given".

The Notes, of course, omit the suggestions in the Bulletin with respect to profit and loss statements as the requirements in that respect are altered in the cases of prospectuses.

Generally speaking, therefore, if the financial statements in a prospectus are prepared in conformity with the suggestions in Bulletins No. 1 and 2 of the Committee on Accounting and Auditing Research they should be acceptable to the Commission. This is subject to the important exception that the earnings statement should show bond interest, provisions for taxes on income and the net profit or loss for each year whether it is a bond issue or a stock issue.

The Commission is willing to review proposed filings before they are in final form so that the required receipt may be issued as expeditiously as possible. In this way unexpected delays at the last moment may be avoided. A prospectus accepted by another province or the Securities and Exchange Commission of the United States is not necessarily acceptable by the Ontario Commission.

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(*Mr. Herington*)

The use of pro forma statements is by no means a recent development. In a memorandum prepared 25 years ago, principles to be applied in the preparation of pro forma financial statements were set out. Those same principles, almost without change, were adopted by the Ontario Securities Commission last year. In the prospectuses which have appeared in recent years, the nature of the proposed transactions has been disclosed in one of two ways. Where the transactions are few in number and relatively simple in character, their effect has been indicated in a separate letter addressed to the Directors of the company. One example of this treatment read as follows:

"If effect were given in the consolidated balance sheet as at December 31, 1946 of A.B.C. Company Limited and subsidiary companies to:

- (a) The issue of supplementary letters patent dated February 18, 1947, providing that the authorized capital of the company shall be \$3,700,000 consisting of 25,000 preferred shares of a par value of \$100 each and 120,000 common shares of a par value of \$10 each,
- (b) The proposed issue of 15,000 4% cumulative preferred shares First Series of a par value of \$100 and the receipt of the proceeds from

the sale thereof at par less commission and other expenses which have been charged to earned surplus, and

- (c) Redemption of 6% First and General Mortgage Sinking Fund Bonds of an aggregate par value of \$857,600 now outstanding,

the result would be—

- (a) To increase 'cash on hand and in banks' by \$567,400 to \$841,083
- (b) To retire 6% First and General Mortgage Sinking Fund Bonds in an aggregate amount of \$857,600
- (c) To increase the aggregate par value of capital stock by \$1,500,000 to \$2,700,000 and
- (d) To reduce earned surplus by \$75,000 to \$2,308,108."

The letter appeared immediately below the auditor's report on the consolidated balance sheet of the company.

Where the transactions are more numerous and complex than in the example cited, the effect is more appropriately shown in a completely adjusted balance sheet. In such cases, the transactions are described in a series of notes placed at the top of the balance sheet and sometimes reference is also made in the report.

I think that we accountants may subscribe to pro forma balance sheets provided the following conditions are met:

- (1) That the interval between the date of the statement and the date of the financing is reasonably short,
- (2) That we are satisfied that there has been no substantial change in the financial condition of the company between the two dates, and
- (3) That a definite contract has been made under which a responsible house has undertaken to purchase the new securities at a fixed price.

I do not believe we should issue pro forma balance sheets giving effect to an issue or proposed issue of securities where the transactions are based on mere options given to investment or brokerage firms to offer the securities at stated prices to the public and to pay the proceeds from such sales to the company if and when received, nor should effect be given to the proposed issue and sale of securities where the company itself is offering the securi-

ties directly to the public. In regard to options, I would make a clear distinction between an agreement under which the investment house or broker may take up all or any part of the issue, and those agreements where the optionee is required to take up the whole of the issue or none at all.

I would like to consider with you for a moment the extent to which the accountant should go in applying the proceeds from the sale of securities to the reduction of liabilities, etc. Effect may be given to the proposed application of the proceeds of new financing provided the accountant can satisfy himself that the funds can and will be applied in the manner indicated. For example, if the funds are applied in part to redemption of outstanding mortgage bonds, the accountant should satisfy himself that the bonds can in fact be redeemed at the option of the company; in most cases it is possible to satisfy yourself on this point by examination of the provisions of the Trust Deed and of the Notice of Redemption. It is not considered necessary that the precise liability shown in the balance sheet before adjustment should actually be paid out of the new money. In the case of bank loans, for example, the application may be made even though, at the date of the issue of the prospectus, such bank loan had in whole or in part been paid out of current receipts subsequent to the date of the balance sheet. The application of funds giving effect to the purchase of fixed assets is not favoured unless there is a firm agreement of purchase at a fixed price. Where the funds are to be applied in part in the construction of a plant or to completion of a plant, it is preferable to show that portion of the proceeds as a separate item under the general caption "fixed assets" rather than to assume a cost for the completed plant, notwithstanding the existence of a firm contract with a reliable contractor. In some cases the balance of the proceeds of an issue has been added to a figure for "cash on hand and in banks." A different and perhaps preferable treatment is to show such balance as a separate item or, in the alternative, add to the caption "cash on hand and in banks" the words "including the balance of the proceeds of the present financing \$——."

Let us now turn to the statement of earnings. It has not been the practice in Canada in recent years to issue

pro forma statements of earnings in the twenties and early thirties. It was a fairly general practice to adjust items of income and expenses to conform to the new conditions brought about by the financing. For example, the provision for income tax was often adjusted throughout the years to conform with the rate of taxation in effect at the date of the prospectus. It is the present practice to report only on the actual earnings and in doing so to apply surplus adjustments to the years to which they properly belong.

It should be recognized that a report on the actual earnings is not in all cases a useful guide to the future. In many cases the new financing arrangements establish an entirely new basis for fixed charges such as depreciation and interest on borrowed money. It may perhaps be said that in such cases it is not an accountant's function to interpret to the investor the information in regard to the past, but merely to report on the facts and to leave it to others to relate the past with the future. There is much to be said for this point of view. However, I believe that, by proper arrangements of the factual information, an accountant's report on the earnings can be made to serve a more useful purpose than a mere tabulation of the annual results.

Under the Dominion Companies Act it is necessary to deal with nonrecurring profits and losses and profits and losses of a special nature. It is not always easy to decide when a profit or loss is nonrecurring or of a special nature. In practice only relatively important amounts which obviously fall within the meaning of the terms need to be disclosed. A consideration of the presentation of the position of a company in regard to past earnings suggests that it would be better not to deal with nonrecurring profits and losses and profits and losses of a special nature by means of footnotes but rather by means of a statement of earned surplus. As already mentioned, the usual interpretation of these terms has been extremely narrow and ordinarily items are not considered as falling within these classes unless they are of a type which would properly be excluded from the profit and loss account in an annual report. The inclusion of a statement of earned surplus in a report on earnings has the added advantage of assuring the prospective investor that all the items in the surplus account

have been brought into account and given consideration in the preparation of the summary of earnings.

In conclusion I would like to make a brief reference to the release dated June 27, 1947, of the Securities and Exchange Commission of the United States. This release dealt generally with the position of independent public accountants in regard to their expression of opinion on the earnings of a company. At one point in the release the following statement is made:—

“In order that investors may make proper use of the summary earnings table and to prevent the possibility of misleading inferences, certain explanatory data are usually necessary. If, for example, the reported earnings reflect the results of unusual conditions, or, in certain years, include significant non-recurring items of income and expenses, an appropriate disclosure of such items or conditions is made, either in the summary or in footnotes thereto. Where applicable, there are also shown in an appropriate manner the anticipated annual fixed interest charges and preferred dividend requirements at the date of registration, after giving effect to any proposed changes in the nature and amount of outstanding indebtedness or securities.”

There have been a few cases where a firm of accountants has expressed an opinion on the earnings of a company or a group of companies, where they have not themselves made an examination of all the accounts from which the figures are derived. True it is that the accountant in such cases makes it clear that he has accepted the work of others, but whenever it is necessary to accept the work of other public accountants, whether or not they are Chartered Accountants, careful consideration should be given to the following words, which appear in the release referred to:—

“Clearly, the mere summarization of detailed financial data prepared or presented by others does not involve most of the fundamental accounting and auditing skills customarily and properly relied upon as giving additional weight to financial statements certified by independent public accountants and adds nothing to the reliability of the underlying information.”



## TAX DEPARTMENT

### INCOME TAX DIRECTIVE NUMBER 71

Issued by the Deputy Minister (Taxation)  
Department of National Revenue  
23rd August 1947

#### ASSESSMENTS—MEDICAL PROFESSION

With reference to the Memorandum regarding Returns of Members of the Medical Profession, issued under date of February, 1943, you are advised that the following modifications are now applicable:

- A. From 1st January, 1947, the maximum cost of a motor car on which depreciation is allowable is increased to \$2,500.00.
- B. Alternative to paragraphs (h) and (i) of the Memorandum is increased to seven cents per mile.
- C. Doctors employed on a salary basis are now allowed the annual dues paid to governing bodies under which authority to practise is issued.

### INCOME TAX DIRECTIVE NUMBER 78

Issued by the Deputy Minister (Taxation)  
Department of National Revenue  
4th September 1947

#### ASSESSMENTS—CATTLEMEN AND DAIRYMEN— BASIC HERDS

The correct treatment from a taxation standpoint of the proceeds of dispersal sales of cattle has continued for some time to be one of the most difficult problems of the Taxation Division. Our difficulty has not been over the theory. It is an axiom that receipts from the sale of a capital asset are not taxable income and where cattle are indeed a capital asset the rule holds true. Unfortunately, it is usually the case that a herd of cattle is built up in such a way—often over a period of years—that it is difficult indeed to say what part of it, if any, is a capital asset.

Because of this difficulty the general disposition of the Division has been to treat the whole of the proceeds of a dispersal sale of cattle as income and, if the taxpayer has not filed an income tax return for several years, to call for averaging of the income back over those years, up to 5 years, in the preparation of the relative income tax returns. This has called forth considerable criticism. Yet the following hypothetical example, which is typical, will show how it works out and why the Division has taken the above position:—

Taxpayer Smith was a farmer who on the 31st December 1940 was worth as follows:

Farm, etc. valued at ..	\$20,000	Liabilities .....	Nil
Livestock .....	Nil	Net Worth .....	\$20,000
	<u>\$20,000</u>		<u>\$20,000</u>

Between the 31st December 1940 and the 31st December 1945, he produced 30,000 bushels of wheat (plus important quantities of feed grains and hay) with a cash value of \$30,000 apart from the



# TAX DEPARTMENT

feeds, a cash cost of production of \$16,000 and a taxable income of \$14,000, or \$2,800 a year average, apart from fodder.

The tax payable was probably \$400 to \$450 per annum.

Being ambitious to diversify his operations he paid out \$2,000 a year in the purchase of breeding cattle, a total of \$10,000. He also used up as feed, oats and other grains on which otherwise he would have realized a cash income. The effect was that his cash income was reduced to an average of \$800 a year and he filed no income tax return at all, since his cash income was less than his married-man exemptions.

By 31st December 1945, he had escaped any taxation on his earnings. His net worth statement, in comparison with that of 31st December 1940, was as follows:

	1945	1940		1945	1940
Farm, etc.			Liabilities	Nil	Nil
valued at ....	\$20,000	\$20,000	Net worth	\$30,000	\$20,000
Livestock .....	\$10,000	Nil			
	<u>\$30,000</u>	<u>\$20,000</u>		<u>\$30,000</u>	<u>\$20,000</u>

NET GAIN .... \$10,000

In 1946, Smith sold his entire herd of cattle at a dispersal sale at \$15,000 cash. The Taxation Division took the position that the entire proceeds were taxable income.

Their view was that the \$10,000 actually paid for the cattle, plus the grain and hay fed to them in five years, would have amounted to \$15,000 in all and that Smith, having invested income for five years without paying tax, could not reasonably complain about having to pay income tax when the investment was cashed in. Under the law, the whole \$15,000 being a cash receipt was taxable in fact in the year 1946. That this ran Smith into a much higher tax bracket in 1946 than he would have been in during the preceding five years is true, but the remedy lay in his own hands from the beginning, namely to declare his true income and pay his tax year by year as he went along.

As he had not filed any return over the five years the procedure of the Division was to allow him to do so retrospectively, to set up his income for each year at what it probably was in truth—the \$15,000 thus being spread back—and, of course, to charge him the statutory interest penalties year by year. He had no basis for complaint, indeed he was being given favourable treatment.

Had Smith paid his taxes year by year his position would have been altogether different, for the Division would then have been able to recognize as capital expenditures the amounts spent in buying cattle, which would probably have been \$1,550 to \$1,600 a year after paying tax, instead of \$2,000 as previously. Thus, they would have allowed \$7,750 to \$8,000 as a capital recovery and not taxable. They would also have treated as non-taxable a reasonable proportion of the rest of the proceeds—regarding it as capital gain.

What this means is that the taxpayer who turns in an income tax return every year and pays any tax which may be due is in a strong position to claim that a considerable part of his herd of cattle is a capital asset when he comes to realize upon it.

In the same way a man who inherits money and buys cattle with it or inherits a herd is in a strong position to claim that it is a capital asset. The same would be true of capital raised from the sale of a farm or some other capital asset. It would be necessary, of course, that he be able to show proof.

These illustrations will make clear some of the principal points involved. They bear in particular on the contention that part of the

# THE CANADIAN CHARTERED ACCOUNTANT

holdings of cattlemen and dairymen should be designated the "Basic Herd" and regarded as a capital asset when sold.

The "Basic Herd" plan contemplates that each cattle or dairy man should be allowed to treat as a capital asset the permanent part of his herd, his breeding stock or his dairy animals and sires. An example of the way this would work is the hypothetical case of taxpayer Jones, who had a net worth statement on 31st December 1940, as follows:

Cattle — 60 head ....	\$3,600	Liability .....	Nil
Farm .....	\$20,000	Surplus .....	\$23,600
	<u>\$23,600</u>		<u>\$23,600</u>

Jones having filed an income tax return year by year up to 1940 and having gone over his past operations carefully, concluded that 50 head of his cattle were his permanent herd and that 10 were offspring intended for sale. After discussing this with the local District Office and showing the records, he obtained that Office's agreement that 50 were the Basic Herd. Year by year thereafter, all sales of cattle which did not reduce the total herd below 50 were included as income in his annual return and all purchases were charged up as a deduction from income. He paid his income tax year by year as he went along.

In 1946 he had 80 cattle on hand and decided to hold a dispersal sale. After confirming with his District Income Tax Office, as a matter of prudent routine, that the 50 figure for Basic Herd still stood, he sold out and realized \$8,000 for the animals, an average of \$100 each. When he came to make up his income tax return for 1946, he was allowed \$5,000 — 50 x \$100 — as a capital realization and \$3,000 was taken into his return as taxable income.

In the light of these illustrations the policy of the Division is re-stated broadly for the two different main groups as follows:

*Group 1: Taxpayers who file Income Tax Returns year-by-year and pay whatever Tax may be assessed:*

These cattle or dairy men will decide for themselves at the end of any one calendar year the number of cattle they consider their basic herd and will advise the District Office of the Taxation Division of this when filing their Income Tax Return for the year. Provided the return is in good order, the District Office will accept the taxpayer's own figure.

The following results will ensue:

- (a) to the extent that sales of cattle do not reduce that number the proceeds of such sales will be taken into income each year.
- (b) the cost of any new animals bought will be allowed as a deduction from income each year, unless it is desired to increase the number of the Basic Herd.
- (c) if in a subsequent year it is desired to increase the number of the Basic Herd, a statement to this effect must be made to the District Office at the time the relative Income Tax Return is filed. The cost of the new animals, if purchased, will not be allowed as a deduction from income. If the additions come from home-grown animals their estimated market value must be added back to the taxable income. Provided the Return is in good order as aforesaid, the District Office will then accept the increased figure for the Basic Herd.
- (d) if a dispersal sale is held of the total herd, the Department will accept as capital realizations and treat as

## TAX DEPARTMENT

non-taxable the proceeds of the sale of the number of cattle constituting the Basic Herd. Unless, before the sale is held, the taxpayer gives the District Office a list of the animals constituting the Basic Herd and then takes care to keep the proceeds of these animals separate, the proceeds of the Basic Herd will be calculated at the average of the proceeds of the sale of all animals, with the provision that where a baby animal is sold with its mother, this is to be treated as a sale of one animal, not two, in calculating the average.

- (e) Where a taxpayer sells off animals to such an extent that he has less than the number of his Basic Herd on hand at the end of the calendar year—so that he has had in effect a partial dispersal sale—the same principles as outlined above will apply. If the taxpayer specifies in advance the animals he is selling out of the Basic Herd and keeps the proceeds separate, the total will be accepted as amount of the capital receipts; otherwise the average price realized for all animals sold will be used in determining the non-taxable amount. The Division's records as to the established Basic Herd will be adjusted downwards where a realization of part of them occurs as above outlined.

### *Group 2: Taxpayers who have not filed Income Tax Returns regularly:*

In this case it is largely a question of proof.

A. A taxpayer who can demonstrate reasonably to the satisfaction of the District Office that in times past—perhaps a long time ago or over a period of years—he purchased a stated number of cattle and at no time deducted their cost in calculating income for taxation purposes or whose income before any such deduction was less than the then existing statutory exemptions and further can satisfy the Division that he has possessed at least that number of the same kind of animals ever since, will be entitled to establish his Basic Herd at that number, provided he files an income tax return in satisfactory form for the year for which it is desired that the Basic Herd be established and for all subsequent years.

B. Where the taxpayer is not in the above class, but can prove that a certain number of livestock were on hand at a certain date, and maintains that they were capital assets by reason of having been built up over a number of years in which he had no taxable income, by the retention of natural increase and/or small purchases from time to time, his claims will be examined carefully and will be admitted if they are found to be reasonable, and if the District Office becomes convinced that the cash value of fodder and other costs of raising the animals, if added to the taxpayer's other income would still have left him in the non-taxable class. In his case also, an income tax return in good order must be filed for the year in which the Basic Herd is fixed.

C. In other circumstances, no part of the livestock holdings will be admitted as capital assets.

Taxpayers in classes A and B above of Group 2, having established their Basic Herd, will be regarded as being in the same class as those in Group 1, provided thereafter that they file an income tax return in proper form each year. The same results will ensue for them in the event of dispersal sales or partial dispersals as for those who have always filed income tax returns.

*Policy as to Taxable Income:*

1. Where the Basic Herd principle is accepted, it follows that the proceeds of the sale of livestock which do not reduce the Basic Herd are income taxable for the year of sale.

2. Where no claim for Basic Herd is made or, if made, is such that it cannot be admitted and the taxpayer has filed no return for several years, the proceeds of dispersal sales may be spread over a number of years, not exceeding five, appropriate to the circumstances. Naturally, a herd of cattle bought out of income in one year for finishing and re-sold the next would not be spread back at all. The proceeds of cattle bought from income as yearlings and carried through to maturity before sale might be spread over two or three years, according to the facts.

It is impossible for us to cover all the situations which will arise in individual cases, and the above is intended as a broad statement of policy. That it is complicated is due to the difficulties which always arise from lack of care about the maintenance of records. The problem is relatively simple where proper books of account are kept. It is unnecessary to say that there is every desire on the part of the Division to be fair but the taxpayer who fails to keep proper records handicaps himself from the beginning. Obviously, the Taxation Division, which is required to look for provable facts in connection with the income and expenses of all taxpayers, cannot make exceptions.

Thus, it is the duty of the Division to recommend earnestly that all livestock and dairy men keep adequate records. This can be done simply if the entries are made without fail on the same day as the transactions occur.

The above statement of policy has in it elements of the experimental and naturally we reserve the right to amend it should abuses occur or should it work unfairly. It is desired that a record should be kept of objections or suggestions for changes so that it may be reviewed in about a year's time.

The Directive will apply to all cases where assessments have not been made or if made have not become final through expiry of the period of one month from date of assessment after which the right of appeal ceases. Where relevant, it will of course apply to cases under appeal.

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## INCOME TAX DIRECTIVE NUMBER 80

Issued by the Deputy Minister (Taxation)  
Department of National Revenue  
6th September 1947

### ASSESSMENTS—FARMERS, GRAIN CARRY-OVER

The institution of a quota on grain deliveries in 1941 prevented many farmers from selling in the year of growth or in the same crop year a large part of their crop. Later quotas were removed or substantially relaxed and, due to a world shortage of grain, farmers were pressed to deliver as much as possible. The result was that incomes in 1944 and 1945 in many instances were larger than would have been the case had there been no quota system. Representations have been made that this imposes a hardship by way of unduly heavy taxation.

To alleviate this in those instances where the farmer was prevented by government control from disposing of his entire crop the following procedure will be adopted in respect of all unassessed re-

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turns and all returns where an appeal or an objection has been made—

The proceeds of grain sold in 1944 or 1945, which was grown in years which were subject to quota, may be added to income of the year of growth, provided—

1. That the farmer can satisfy this Division that he sold grain to the full extent of his quota each crop year, and
2. That the grain carried over as a result of quota restrictions was sold on or before 31st July, 1945.

In other words, where carry-over was by voluntary action on the part of the farmer, he will be taxed on a strictly cash basis, but where a farmer has demonstrated by subsequent sales that presumably he would have sold his entire crop in the year of growth or the same crop year an accrual basis as to sales will be permitted.

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### **INCOME TAX DIRECTIVE NUMBER 81**

**Issued by the Deputy Minister (Taxation)**

**Department of National Revenue**

**6th September 1947**

#### **ASSESSMENTS — SALARIES DISALLOWED AS EXPENSES**

Under subsection two of section six of the Income War Tax Act, the Minister has power to disallow any expense which is determined to be in excess of what is reasonable or normal for the business. Subsection three of the same section provides that the Minister may decide what portion of any salary, wage, fee or bonus shall be treated as investment income.

The application of both of the above subsections is covered by Memo No. 81 (1946-47), issued under date of 24th February, 1947, and given Public Circulation. Therefore, in applying either one the provisions that Memorandum must be followed. The question has arisen, however, as to the proper treatment in the recipient's hands of any amounts disallowed as an expense to the employer.

This is to advise you that, in all cases, the amount of any remuneration disallowed under Section 6(2) should be treated as investment income if it is retained by the recipient. If, however, as is often the case with closely held Corporations, the recipient desires to repay the amount disallowed to the employer we will, upon receipt of proof that the amount has in fact been repaid, treat only the amount retained by the recipient as taxable income in his hands.

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### **INCOME TAX DIRECTIVE NUMBER 96**

**Issued by the Deputy Minister (Taxation)**

**Department of National Revenue**

**1st October 1947**

#### **ASSESSMENTS — CLERGYMEN**

We have decided to cancel the existing ruling that the estimated rental value of the manse occupied rent-free by an ordained member of the clergy shall be added back to his cash income for taxation purposes. In most, if not all, cases, the manse is not in effect the clergyman's private residence but a place provided by his church in which, by design, he carries on part of the duties of his office.

This ruling will apply to:

- (a) Assessments which have not yet been made;
- (b) Assessments made but not statute-barred and
- (c) All appeals.

As regards the expense of running automobiles, it is still our view that no different position can be admitted for the clergy than for the laity. The best plan is for the clergymen to be reimbursed by the church for their actual expenses as shown by vouchers.

**LEGAL DECISIONS**  
**RESPECTING THE INCOME WAR TAX ACT**  
**OF CANADA**  
**TAX ON SERVICE PAY AND ALLOWANCES**

James M. McLean, Appellant

—and—

The Minister of National Revenue, Respondent

(The Exchequer Court of Canada, O'Connor, J., 15th August 1947)

During 1943 the appellant was a member of the Canadian Forces in the Western Hemisphere other than in Canada for part of the year and in the Canadian Active Service in Canada for the balance of the year.

The appellant filed a T.1 general return for 1943 and a T.1 armed forces supplemental, claiming that under Rules 2 and 3 of Section 3 of Paragraph A of the First Schedule he should pay, under Rule 3, tax only on his total service pay and allowances received in 1943 at one-half the effective rate of tax applicable to his total income and from this should be deducted the tax credit under Rule 2 of \$324.76.

The appellant was assessed a total tax of \$984.72, less the credit under Rule 2 of \$324.76, less a further credit equal to one-half the effective rate of tax applicable to his total income in respect to his service pay and allowances received only during the period he served outside Canada.

**HELD:**

"The questions are:—

*First*—are the pay and allowances mentioned in Rule 3 those received during the time the member was in the Western Hemisphere other than in Canada, or do they also include the pay and allowances received by the member in Canada?

*Second*—does the applicant pay the tax imposed by the general taxing sections of the Act less the credit allowed by Rule 2, and on his service pay and allowances at one-half the effective rate of tax applicable to his total income,

or

in lieu of paying the tax otherwise payable under the Act in respect to his total income, does he *only* pay on his service pay and allowances and then only at one-half the effective rate of tax applicable to his total income less the tax credit allowed by Rule 2.

Under the Act, in my opinion, there are four groups of members of the Canadian Naval, Military and Air Forces.

(1) The income including service pay and allowances of those members of the Forces in Canada who are not in the Canadian Active Service, is subject to taxation.

(2) The income including service pay and allowances of those members in the Canadian Active Service who are in Canada, is

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subject to taxation but under Rule 2 the tax they pay is "reduced by a credit from the tax otherwise payable", ranging from "an amount equal to the tax payable on \$1,600.00" of pay and allowances, on up.

(3) Under Rule 3 the income including pay and allowances of all members of the Forces in the Western Hemisphere other than in Canada is subject to taxation because they, under Rule 3, "shall be dealt with in the same manner as the persons referred to in Rule 2 of this section". And the persons under Rule 2 are given "a credit from the tax otherwise payable". They are then subject to the general taxation provision and receive a credit on their tax depending on the amount of their pay and allowances as provided in Rule 2. But there is one exception under which they get additional relief. That is, that they "shall in respect of his service pay and allowances be subject to tax at one-half of the effective rate of tax applicable to his total income".

(4) Under Section 4(t) (i) the service pay and allowances of members of the Forces while in the Canadian Active Service Forces and Overseas on the strength of an Overseas Unit outside of the Western Hemisphere and certain others described in subsections (ii) and (iii) is not liable to taxation at all. Their income other than pay and allowance is taxable.

A member of the Forces could be and no doubt was in all four groups in the course of one year. But as the Act does not provide otherwise, I come to the conclusion that each exemption would only be applicable to the pay and allowances during the time the member was in that particular group.

Rule 3 is clearly an exempting section and not a taxing section and must, therefore, be construed strictly. *Wylie v. City of Montreal* (1).

In my opinion the appellant is only entitled to the reduced rate of taxation in respect to the service pay and allowances received while he was in the Western Hemisphere other than in Canada.

Rule 3 first provides that the member "shall be dealt with in the same manner as the persons referred to in Rule 2". And as I have already pointed out those persons pay a tax on their income including pay and allowances and that tax " . . . shall be reduced by a credit from the tax otherwise payable . . ." So that under Rule 3 a member pays a tax on his income including pay and allowances and receives the tax credit provided by Rule 2. Then because he is away from Canada the Rule provides that he is to receive a further exemption, i.e., his pay and allowances are taxed at one-half the effective rate applicable to his total income.

If the appellant's contention was correct all private incomes of members in the Western Hemisphere other than in Canada would be exempt from tax. That would be an even greater exemption than given to the fourth group (*supra*) i.e., those serving overseas.

In fairness to the appellant I should add that while he contends that wording of the section places a tax only on pay and allowances and then at one-half the rate applicable to the entire income, he does not suggest that that was the intention of Parliament. But he does contend vigorously that that is what Parliament has done.

I do not agree with either of the appellant's contentions.

While the rule directs that the pay and allowances be taxed at one-half the effective rate of tax applicable to the total income, the respondent has computed the tax at the full rate and has then given a tax credit equal to one-half the rate applicable to the total income on the pay and allowances. This, of course, produces the same result.

The proper construction of the section was admitted by counsel



to be difficult. The appellant is a Solicitor and issued the Statement of Claim himself, and did not ask for costs in the Claim.

In addition he appeared on the appeal so that if the appeal had been allowed no costs could have been allowed.

"For the reasons I have given, the appeal will be dismissed and under the circumstances without costs."

### PAYMENTS ON ACCOUNT OF CAPITAL

Bennett and White Construction Company Limited, Appellant  
— and —

The Minister of National Revenue, Respondent

(The Exchequer Court of Canada, O'Connor, J., 18th August 1947).

From 1935 to 1942 advances from the bank were secured upon the giving of guarantees by the directors of the company. The company paid to the directors, in consideration for this act, a commission equal to the interest paid by the company to the bank. These advances enabled the company to undertake about three times the construction work than they would otherwise have been able to do and thereby they were able to increase their profits. From 1935 to 1940 these commissions paid to the directors were allowed as expenses against income but in 1941 and 1942 the amounts were disallowed under Section 6(1)(a) and further, that the amounts paid were payments on account of capital within the meaning of Section 6(1)(b).

#### HELD:

"The borrowings cannot be termed 'temporary accommodation' but are obviously borrowed capital used in the same way as its own capital. The interest paid to the bank each year on these borrowings has been claimed by the appellant and allowed by the respondent under Section 5(b) as 'interest on borrowed capital used in the business to earn the income'. That being the only section under which it could be allowed. In statement (2) attached to the Auditors' Report for the year 1941, interest in exchange of \$43,998.96 is shown and for 1942, \$49,706.88. The evidence showed that these items included both the interest paid to the bank on the borrowings and the commissions paid to the guarantors, and were lumped together for convenience. And as Lord MacMillan pointed out Section 5(b) significantly employs the expression 'capital used in the business to earn the income', thus differentiating between the provisions of capital and the process of earning profits.

"It was contended that, as the borrowings could not be obtained without the guarantee and the guarantee could only be given if the commissions were paid, the commissions were necessarily laid out to earn the increased income. But the commissions were paid in order to borrow this additional capital and are therefore part of the 'financial arrangements' of the Company. The increase in income resulted from increase in capital.

"The commissions were expenditures incurred in relation to the financing of the business, and in the language of Lord MacMillan 'their financial arrangements are quite distinct from the activities by which they earn their income'.

"These commissions were not, in my opinion, expenditures incurred in the earning of the income within Section 6(1)(a). For these reasons I am of the opinion that the assessments in question were properly made.

"The appeal must be dismissed with costs."

## INCOME "DERIVED" FROM TAX EXEMPT SECURITIES

Lady Virginia Kemp, Appellant

— and —

The Minister of National Revenue, Respondent

(The Exchequer Court of Canada, Thorson, P., 12th September 1947)

Under the provisions of the will of the late Sir Albert Edward Kemp, the appellant was to receive the income from a portion of the estate. The will provided that the provisions in favour of the appellant were a prior charge on the estate. In order to allow for the distribution of part of the estate the appellant agreed to the setting up of a special trust fund, on the books of the trustees, to provide for the payment of the obligations to her. The fund, set up in early 1930, consisted of a substantial amount of Dominion of Canada 5½% bonds due 1st December 1937, as well as some cash. Additional bonds of the same issue were purchased in later years. These bonds were exempt from income tax within the meaning of Section 4(j) of the Act. Up to the end of 1937 the gross income of the fund was \$93,520.55 in excess of the total payments required to meet the obligations of the will. When the bonds matured in 1937 they were replaced by securities, the income of which was not free of tax. In 1938 the income of the fund was more than sufficient to meet the requirements but it was short by \$3,995 in 1939, \$6,333 in 1940 and \$16,232 in 1941. The appellant contended that the accumulated revenue out of which the foregoing deficiencies were made up was income derived from income tax exempt bonds and in the absence of legislation imposing tax thereon, retained that character until they reached the hands of beneficiary under the will. The appellant appealed the assessments in respect of the years 1938 to 1941 inclusive.

## HELD:

"The whole accumulated revenue consisted of income received by the Trustees as interest on income tax exempt bonds and was exempt from income tax under section 4(j) of the Act. In my view, it lost none of that character on being lawfully transferred by the Trustees to the appellant in partial discharge of the obligations to her under paragraph 4 of the will.

"But even if the income received by the appellant under paragraph 4 of the will were not the same as that received by the Trustees as interest on income tax exempt bonds, it does not follow that it would be subject to income tax, for proper regard must be had to the meaning of the word "derived" in section 4(j). Counsel for the appellant contended that it must not be read as meaning "received in the first instance". I agree. In a taxing Act words must, generally speaking, be given their plain and ordinary meaning, and, according to such meaning, the word "derived" covers a wider field than the word "received", and when applied to the word "income" it connotes the source or origin of such income rather than its immediate receipt. . . . The word was recently carefully construed by this Court in *Gihooly v. Minister of National Revenue* (1) by Cameron J., then Deputy Judge, when he had to consider whether the moneys received by the executors of an estate as dividends on shares held by it in a mining company and paid to a beneficiary entitled to a share of the income of the estate constituted in the hands of such beneficiary "income derived from mining" within the meaning of section 5(a) of the Act, so as to entitle her to a depletion allowance. He came to the conclusion that they did.

"Similarly, it seems to me that the word "derived" in section 4(j) of the Act as applied to the income there referred to cannot be

limited to income from income tax exempt bonds immediately or directly received by the owner thereof as interest thereon, but must include income that has its source in such bonds even although there may be intervening channels through which it flows from such source to its final destination. The word, in my opinion, is wide enough to include the payments received by the appellant under paragraph 4 of the will, to the extent that they came out of the accumulated revenue of \$93,520.55 made up of balances of interest on income tax exempt bonds received by the Trustees. To such extent they were, in my judgment, income derived from income tax exempt bonds within the meaning of section 4(j) of the Act and not liable to taxation. To the extent of such payments, namely, \$3,995.98 in 1939, \$6,333.36 in 1940, and \$16,232.22 in 1941, the appeals from the assessments for such years must be allowed and the assessments set aside for amendment accordingly. There being no evidence that any sum was paid to the appellant out of tax exempt income in 1938, the appeal from the assessment for that year must be dismissed.

"This leaves only the question of interest and penalties on the unpaid amounts of income tax as from the date at which they ought to have been paid. Counsel for the appellant urged that it had been necessary to go to the Court for interpretation of the testator's will on a number of points including questions affecting the amount of the appellant's income tax liability and that in view of the difficulties involved in determining such liability interest and penalties, or at any rate the latter, should be computed only as from the date of assessment, namely, November 29, 1943.

I have come to the conclusion that under the state of law governing the matter the Court is powerless to grant the relief sought and that if any relief is to be afforded it must come pursuant to an Order in Council under the appropriate legislation dealing with such matters as the remission of penalties and the like. . . . Counsel for the respondent pointed out that, although this section, as later amended, was repealed in 1944, the repeal could not help the appellant; and that its terms are mandatory and leave no discretion as to relief from it with the Court. I agree. . . .

"In the result the appeal from the assessment for the year 1938 is dismissed with costs and the appeals from the assessments for the years 1939, 1940 and 1941 are, to the extent indicated, allowed with costs."

### "RATE" OF SALARY

The Great Western Garment Company Limited, Appellant  
— and —

The Minister of National Revenue, Respondent

(The Exchequer Court of Canada, O'Connor, J., 19th August 1947)

In June 1941, at its annual general meeting, the shareholders passed a special resolution which appointed the Managing Director as from 1st January 1941 at a certain salary *free from income tax*. Another resolution provided that the salaries of four other Directors be *free from income tax*, effective 1st January 1941.

The company paid the officials in accordance with the above, making the necessary entries on the records and filed income tax returns on which it claimed as expenses the salaries and taxes thereon, which had been paid in accordance with the resolution. The increase in income tax rates for 1943 and 1944 had the effect of increasing the amount the company was required to pay over that paid in the base year. The Minister disallowed the sum of \$30,791.97 for 1943 and \$26,868.34 for 1944 under paragraph 7 of the Wartime

## TAX DEPARTMENT

Salaries Order, Order-in-Council P.C. 1549, dated 27th February 1942, as amended, subsection (2) Section 6 of the Income War Tax Act and Subsection (b) Section 8 of the Excess Profits Tax Act contending that the sums disallowed were in excess of the amount permitted by Section 2 of the Wartime Salaries Order and further, that none of the proceedings at the meeting of shareholders conformed to the constitution of the company and the act and that the resolutions were not validly passed.

### HELD:

"These resolutions had the effect of increasing the salaries of four of the six directors of the Company. "Each of the four directors was prohibited from voting by Section 92 of the Articles in respect of any contract or arrangement entered into by or on behalf of the Company in which he shall be in any way interested. The second resolution constituted a contract with three of the directors which was within the prohibition of Article 92. . . . In my opinion, making the salaries of these four free of income tax formed part of one transaction in which all four were equally interested and that all four would be prohibited from voting. . . . While the directors had the power to increase their salaries, they were, in my opinion, by reason of Article 92, unable to exercise it. But even if they were able to exercise this power, they were unwilling to do so and quite properly brought the matter before the shareholders. . . . By placing the resolutions before the general meeting, the directors in effect, recommended that this be done. The ordinary shareholders approved the resolutions unanimously. The officials acted on the faith of the resolutions. So did the Company as shown by the entries in the books of the Company, and in the income tax return filed. . . . For the reasons I have given, I hold that these resolutions passed at the general meeting were valid.

"The respondent contends that the result of these resolutions was to materially increase these salaries during the years that followed, and that such increases were directly opposed to the spirit of the Wartime Salaries Order which was made to prevent inflation. The employees undoubtedly received a much higher income as the result, and there was, therefore, a corresponding increase in the cost to the employer.

"The resolutions, however, were passed eight months before the Wartime Salaries Order was made and the practice of making salaries income tax free had been inaugurated by the appellant as early as 1920.

"The Company was not, therefore, attempting to evade the provisions of the Order. It quite properly desired to carry out the obligation it had undertaken.

"The question is simply, can the resolutions be lawfully implemented within the provisions of the Salaries Order. . . . The decision of the Minister shows that the respondent treated the amount paid for income tax as a bonus, and under section 2(d) disallowed the amount in excess of the salary and income tax for the base year defined by the Order, as the year commencing the 7th day of November, 1940, and ending the 6th day of November, 1941. The statement of defence alleges that the amounts disallowed represent increases in the rates of salary paid to those officials in 1943 and 1944 respectively, above the most recent rates established and payable to them prior to the 7th November, 1941, as set forth in section 2(a) of the Order.

"The next question is whether the payment of the income tax is a bonus within section 2(d) of the Order. Bonus is not defined by the Order, but the meaning given by Webster's International Dictionary is, "Something given in addition to what is ordinarily received by,

or strictly due to, the recipient". The Oxford Concise Dictionary defines bonus as,—“Something to the good, into the bargain (and as an example) . . . . gratuity to workmen beyond their wages”. . . . Here, . . . . “free of income tax” is not something in addition to or in excess of that which is to be received, but is part and parcel of the salary. In my opinion the payment of the income tax is not a bonus within section 2(d) of the Order. . . .

“Section 2(d) prohibits the payment “as bonus” of a larger total amount “to a salaried official” than the “total amount” paid as bonus in the base year. Section 2(a) does not deal with “total amounts” at all. It prohibits an increase in the “rate of salary” paid to a salaried official above the most recent salary rate established and payable prior to November 7th, 1941.

“The words “established and payable” refer to the “salary rate” not to the amount of salary.

“Under section 2(a) it is the employer who is prohibited from increasing the rate. In this case the employer has not increased the rate, the increase in the amount results from an increase in the income tax rate.

“The “rate of salary established and payable” for each official by these resolutions was the number of dollars plus the tax payable by each official on those dollars. . . . In my view there was no increase in the “rates of salary” paid to those officials in 1943 and 1944 above the most recent rates established and payable to them prior to the 7th November, 1941. . . . The resolutions, however, do not provide for any subsequent increase in rate of salary. They established a rate of salary prior to the 6th November, 1941, which was applicable both prior to and subsequent to that date.

“In my opinion the amounts in question should not have been disallowed under section 7 because they were not in violation of section 2 of the Order.

“The appeal will be allowed and the assessments will be referred back to the Minister for an adjustment of the figures consequential on the allowance of the appeal.

“The appellant is entitled to the costs of the appeal.”

## Personals

Nathan Freeman, Chartered Accountant, wishes to announce the opening of an office at 123 Simcoe Street, Toronto for the practice of his profession.

Claude Abrams, Chartered Accountant, wishes to announce the removal of his office to 123 Simcoe Street, Toronto.

The Institute of Chartered Accountants of Saskatchewan announces the appointment of Mr. William H. Cook C.A., of Regina, Auditor of Utilities, Province of Saskatchewan, as Secretary of the Institute. Mr. Cook replaces Mr. E. C. Gerry, who has left Regina to engage in public practice at Prince Albert.

I. Edward Basin, B. Acc., Chartered Accountant, announces the removal of his office to 402-3 Northern Crown Building, 1821 Scarth Street, Regina, Saskatchewan.

## Book Reviews

**Precision and Design in Accountancy**, by F. Sewall Bray  
published by Gee & Co., (Publishers) Ltd., London. 15s 6d  
postpaid.

This book has been read with a great deal of interest and is of a type that one wishes to go back to for re-reading as opportunity offers. This reader has been fortunate enough to see the review published in "The Accountant" of September 13, 1947 and with grateful credit to it reprints its comments in full.

"In this slim volume of 145 pages Mr. Sewall Bray has drawn upon a number of articles and letters which have been accessible in the past only in the files of *The Accountant*, *The Incorporated Accountants' Journal*, and *Accountancy*, and also upon some unpublished material prepared for the Research Committee of the Society of Incorporated Accountants. The whole is welded into one by the addition of matter necessary to provide continuous and complete treatment of the subject.

The broad object of the author has been to find a path upon which accountancy and economics can travel together and be helpful to one another. He endeavours to provide the accountancy profession with a philosophy, and to examine its technique in the light of the criticisms of economists. He says:

"There was a time when, as professional accountants, we felt that if we had satisfied the proprietors of an enterprise and had dealt with the claims of the Inland Revenue, that was about as much as we were called upon to do, but we now find other interests are slowly coming to the fore. Apart altogether from questions of taxation, the Government has many difficult social and economic problems to solve, which may require some reference to statistics drawn from accounting documents. Net operational profits are coming to be regarded as indices of efficiency, while our published profit and loss accounts are beginning to be expected to show the share of the final product accruing to the various factors of production, particularly those of labour and management. Economists are also turning to our accounts in an endeavour to formulate statistics of comparative costs."

The author's view of the philosophy underlying accounting is based on the thesis that economic order leading to conceptions of equilibrium or balance is essential to social stability. Given any form of measurement by monetary symbol, he contends, the accounting art then becomes essential to economic order. Although emphasis is thereby laid upon the utilitarian character of accounts, the philosophy does not neglect the social aspects lying behind both the structure and mechanism of business:

"And so we arrive at the point where accountancy may be thought of as a systematic record of the working of the economic structure of society in terms of monetary symbols. As it takes on and develops notions of economic order, it gradually points to what *should be* by accuracy of statement in regard to what *is*."

After discussing the background of the accountant's art and the training and study necessary for a wide view of the functions of ac-

## THE CANADIAN CHARTERED ACCOUNTANT

counts, Mr. Sewell Bray considers the approach to economic science, and comes to the statement made by the late Lord Stamp in 1921, that scientific accountancy had been developing for fifty years but had made no single substantial contribution to economic science over its own field of analysis of the results of industry. Mr. Bray appears to accept this statement as true until of recent years, and to explain it by reference to the fact that accountants have been concerned with the essentially practical problems which arise in the field of applied economics, while the earlier economists tended to pursue the scientific study of human behaviour in its economic relations with an air of the austere abstraction relevant to a pure science.

It cannot, of course, be doubted that accountants have neglected the study of economic science, and consequently have been unable to contribute to that science anything even of what was in their power to do.

A fundamental difficulty has always been that the accountant does not deal in values, but in costs; and costs do not seem to interest economists who on their part are concerned only with what they call real values. The general attitude of accountants in this matter was probably correctly stated by the Committee on Accounting Procedure of the American Institute of Accountants in these words:

'In thus emphasizing the fact that accounting values are predominantly costs, the Committee would like to make clear its view that costs are in general much more real and much more significant to those who use accounts, than values in the general meaning of that word.'

Mr. Bray's discussion of accounting technique and research covers the development of accounting functions, an accounting statement of profit, theoretical conceptions of fixed asset valuation, legal decisions regarding the measurement of profit, depreciation, accounting and management, uniform accounting and accounting standards. The greater part of these chapters shows the influence of the attempt to reconcile accounting and economic concepts, sometimes by bridging the gap between the two and sometimes by indicating the difficulties which seem to make certain gaps completely unbridgeable. Thus the economic conception of values is rendered difficult of realization in accounts by the existence in the legal mind, to which accountants must give deference, of a preference for accounting statements in terms of cash rather than in terms of asset movement. Again, the question of depreciation is dealt with approvingly by a definition which treats it as a distribution of the cost or other basis value of an asset over its estimated useful life; an answer which seems so far to exclude the economic view of provision for replacement values. Later on, when discussing this difficulty, Mr. Bray is compelled to make the suggestion of reconciling the two ideas by means of an adjustment on the accountant's method to meet the requirements of the economist—in other words, by duplicate statements.

There is printed as an appendix an extremely interesting interchange of letters between the author and Dr. H. W. Singer, with an illuminating intervention by Mr. Harry Norris, on the subject of the measurement of profits, to which we hope to return later.

Though the book is not large, it is packed with thoughtful writing which is obviously the fruit of years of study and is rare in English accounting literature for its breadth of range. Some of it is theoretical, but it is so in the best sense. That is to say, the theory is used in an effort to throw a bridge from one practical point to another. A developing profession like accountancy, with increasing responsibilities being piled upon it, and with an enlarging status being



## BOOK REVIEWS

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accorded to it, must grow in mental stature both as a whole and through its individual members. Mr. Bray's discussion will do much to further that end and his book must be read by all who have the future of the profession at heart."

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**Practical Financial Statement Analysis** by Roy A. Faulke, published in the U.S.A. by McGraw-Hill Book Company, Inc., New York, price \$6.50 U.S., 681 pages.

The author, vice-president of Dun and Bradstreet Inc., has written a very comprehensive and practical work on statement analysis. Primarily his viewpoint is that of a credit man, but this enhances, rather than detracts from, the value of the work to management and to accountants.

The work is divided into seven parts—the historical and credit background leading up to the analyses of financial statements and a discussion of the varying interpretations placed upon the results so obtained by parties with different interests and varying degrees of knowledge of supplementary factors, the analysis of small business enterprises by the breakdown of sales income, the internal analyses of balance sheets and a detailed discussion of such ratios as current assets to current liabilities, current assets to tangible net worth, funded debt to net working capital and net sales to inventory, comparative analysis of balance sheets, analysis of profit and loss statements including a discussion of the "break-even" point, and surplus accounts. The final chapter is a discussion of the evolution of accounting principles and practice and a clear exposition of the factors necessary for a clear understanding of financial statements.

Each chapter contains well worked out examples, based on business case histories, which illustrate the techniques described and the points being emphasised.

### QUEBEC ACCOUNTANTS' ACT

The following is the text of an Act amending "An Act to Regulate the Practise of Accountancy and Auditing" passed by the Quebec Legislature in April 1946 and reprinted in the July 1946 issue of THE CANADIAN CHARTERED ACCOUNTANT.

AN ACT TO AMEND THE ACT TO REGULATE THE PRACTICE OF ACCOUNTANCY AND AUDITING

[Assented to, the 10th of May, 1947]

**H**IS MAJESTY, with the advice and consent of the Legislative Council and of the Legislative Assembly of Quebec, enacts as follows:

1. The Act to regulate the practice of accountancy and auditing (10 George VI, chapter 47) is amended by adding after section 23, the following:

"23a. The provisions of section 23 shall not apply to members admitted by the International Society of Commerce Limited after the 17th of April 1946.

The then existing list of members shall be furnished under the authority of the presidents, Mr. Lucien Charest for the district of Quebec and Mr. Emile Langlais for the district of Montreal and deposited with the Quebec Provincial Secretary within 90 days from the sanction of this act.

Such list shall be supported by a sworn declaration of each member.

Paragraph c of subsection 1 of section 11 shall not apply to members of "The International Society of Commerce Limited".

2. The said act is amended by adding thereto, after section 26, the following:

"26a. No person shall,

a. if he be the Kings printer, publish in the *Quebec Official Gazette* a notice that a bill will be presented to either House of the Legislature conferring membership in the Institute or the right to practise as a public accountant, or

b. if he be the clerk or clerk of private bills of one of the Houses of the Legislature, receive any such bill or have it printed,

unless during the period of one year, as from the sanction of this act, the notice or bill be accompanied by a certificate establishing that the bill has been submitted to the Council of the Institute and after this period, has been approved by the council of the Institute."

3. Any person who under the provisions of section 11 of the act 10 George VI, chapter 47, had the right to apply in writing to the Institute of Chartered Accountants of Quebec for a license to practise in the Province as a public accountant but did not do so within the delay mentioned in the said section 11, shall have the right to make such application at any time within one hundred and twenty days after the coming into force of this act with the same legal effect as if such application had been made within the delay provided by the said section 11.

4. This act shall come into force on the day of its sanction.

## Provincial News

### British Columbia

The results of the recent Law Examinations of The Institute of Chartered Accountants of British Columbia have just been announced. In the Final Examinations, fifteen candidates were successful, first place being attained by D. J. Kelsey and second place by J. W. Hudson. Other successful candidates were K. S. Beaton, Ian H. Bell, J. S. BurrIDGE, A. P. Downs, D. H. Dunn, H. F. Field, B. E. Harrison, F. H. Harwood, Miss A. E. Jost, W. L. Kent, R. M. Pollock, Mrs. M. H. Redford, J. M. Standeven. In the Intermediate Examinations thirty-eight candidates were successful, first place being attained by B. C. Morton and second place by J. J. Hope. Other successful candidates were E. C. Akhurst, W. D. Alexander, L. A. Baldock, Miss Jean Beddome, A. D. Browne, Miss M. S. Cowley, J. B. Ewing, Fred. Graham, M. D. Graham, B. D. Graves, W. G. Gray, J. McG. Hamill, Miss C. M. Hacking, J. K. Hancock, G. E. Holmes, A. Hunter, J. A. Johnson, G. C. B. Kellett, W. H. Kitto, J. H. C. Lane, J. D. Manson—(aegrotat standing), C. G. Manzer, W. R. Myhill-Jones, R. J. Nation, D. L. O'Brien, E. J. O'Connell, A. H. Rathie, Jr., J. I. Rawlinson, D. H. M. Ross, S. Routledge, D. W. G. Smallbone, J. W. Stacey, R. J. Taylor, W. S. Wate, Miss E. Wragg and R. C. Yolland.

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### Calgary Chartered Accountants' Club

The first meeting of the fall season of the Calgary Chartered Accountants' Club took the form of a luncheon at the Renfrew Club in Calgary on September 24th. The retiring President, Mr. A. J. Burton, gave an outline of the activities of the previous year and Mr. R. J. Snell, Secretary-Treasurer, read the financial statement for the past year and answered queries thereon from the members of the club. Mr. C. V. Milne gave a report on the Bowling Club activities for the coming year.

The election of officers for the coming year was held and the following were the unanimous choice of the club: President—Mr. Clarence A. Richards; Vice-President—Mr. R. J. Snell; Secretary-Treasurer—Mr. J. R. Hardie.

## Obituaries

### The Late Walter Harold Briggs

The Institute of Chartered Accountants of Saskatchewan announces with regret the passing of Walter Harold Briggs. Mr. Briggs was born in Windsor Mills, Quebec in 1889 and has been a member of the Institute of Saskatchewan since 1920. He has practised his profession in Saskatoon since admission.

Surviving are his widow; one son, Vincent Allen; two daughters, Alice and Janice; one sister, Ethel Briggs of Weston, Ontario; and one brother, A. F. M. Briggs of Weland, Ontario.

To his family, the members of the Institute extend their sincere sympathy.

### The Late Alex. J. J. Fanshaw

The Institute of Chartered Accountants of Alberta together with the Institute of Chartered Accountants of Manitoba announce with regret the death of Alex. J. J. Fanshaw, C.A., on the 6th October 1947.

Mr. Fanshaw was born 17th January 1882 at Wolverhampton, England, and became an Associate of the Institute of Chartered Accountants of England and Wales in 1905. He came to Canada in the year 1912 to take a position on the staff of Webb, Read & Hegan, which firm was amalgamated with George A. Touche & Co., in 1919. In 1928 he was placed in charge of George A. Touche & Co.'s office in Calgary as resident partner.

He was admitted to the Manitoba Institute in April, 1913, and to the Alberta Institute in August, 1928, and retained his membership in both the Manitoba and the English Institutes until his death.

In 1914 he married Beatrice Matthews of Brighton, England, who survives him; their daughter is married and living in New Zealand.

Mr. Fanshaw served six years on the Council of the Alberta Institute and was President for the year 1935-36.

Mr. Fanshaw was present at the last Annual Meeting of the Dominion Association and represented The Institute of Chartered Accountants in England and Wales at the Annual Luncheon. To Mrs. Fanshaw and daughter we extend our sympathy.

## Current Accounting Literature

### The Fund Theory of Accounting

An important addition to accounting literature and thinking has been made by Professor W. J. Vatter of the University of Chicago in his booklet "The Fund Theory of Accounting and its Implications for Financial Reports", published by the University of Chicago Press. The fund theory of accounting is markedly different from the proprietorship and entity theories and follows much more closely the economic approach. The accounting unit is a fund of homogenous economic assets working to a common end and there are several such funds in any normal industrial company, such as the fixed asset fund, the working capital fund, the investment fund, and so forth. Since these classifications are not homogenous, they should not be accounted for in a single statement (balance sheet) according to the fund theory. Professor Vatter's book includes a complete set of statements for an industrial concern drawn up on the fund principle, which is commonly used by municipalities, universities and similar institutions.

While the book is written in extremely technical language and is often difficult for the layman to follow, it should be read by all who are interested in the development of sound accounting theory and principles.

### U.S. Accounting Research Bulletin No. 30

The latest in the series of bulletins issued by the Committee on accounting procedure of the American Institute deals with the definition of working capital and the accounting principles involved in working capital valuation and transactions. Working capital figures are of prime interest to granters of credit and also to prospective investors, and up to the present time there has been too little uniformity in

#### PUBLICATION ADDRESSES, AND PRICE PER COPY POSTPAID

- Accountancy, Incorporated Accountants' Hall, Victoria Embankment, London, W.C. 2, England. 1 shilling.  
 Accountants' Magazine, 23 Rutland Square, Edinburgh, Scotland. 1s. 3d.  
 Accounting Review, School of Commerce, Northwestern University, Evanston, Ill., U.S.A. \$1.  
 The Accountant, 42 Baker St., London W. 1., England. 1 shilling.  
 The Controller, 1 East 42nd St., New York, N.Y. 50 cents.  
 Cost and Management, 66 King St. East, Hamilton, Ont. 35 cents.  
 Harvard Business Review, Harvard University, Boston, Mass., U.S.A. \$1.50.  
 Journal of Accountancy, 13 East 41st St., New York, N.Y. 85 cents.  
 The Internal Auditor, 59 Atlantic Street, Stamford, Conn., U.S.A. \$1.  
 National Association of Cost Accountants, 385 Madison Ave., New York. 75 cents.  
 Taxes—The Tax Magazine. CCH Canadian Limited, 31 Willcocks St., Toronto, Ont. \$6.00 per year. (American Publication).

the items classified as current assets and current liabilities and the bases of valuation. This bulletin recommends the business cycle rather than the twelve-month period for determining whether an item is current or fixed capital and it stresses that cash and securities earmarked for capital expenditures, redemption of long-term debt, or similar purposes, are not to be included in working capital. The statement should go far towards standardizing this important section of the balance sheet.

#### **Reserves to Equalize Income**

The N.A.C.A. Bulletin of 1st September contains a brief but outspoken article by E. A. Carlson denouncing the use of various types of reserve for the indirect purpose of equalizing corporate income. The practice was greatly accentuated during the war when general reserves for post-war rehabilitation and similar contingencies were common, but it did not stop with the war. Record postwar profits made management more anxious to set up such reserves and a new crop of inventory and contingency reserves has now appeared. While it is difficult to argue that such reserves may not be very necessary in the years ahead, the author makes a strong case for their proper treatment and disclosure in financial statements.

#### **Analysis of Distribution Costs**

In the same Bulletin, H. I. Arenson has contributed a survey of the distribution cost problem, recommending that some cost system be installed and developed rather than permit the accounts to remain without such a system until the distribution cost problem has been solved. His three methods of distribution cost analysis are: analysis by nature or object of expense; functional analysis; and analysis by manner of application. Some combination of all three is most generally used, as all three are, in fact, interrelated.

#### **Costing**

The 15th September N.A.C.A. Bulletin contains three articles on different phases of cost accounting—costs for plans and policies by W. W. Miller; developments in cost control by W. P. Fiske; and clerical cost control by H. F. Van Gorder. The first paper deals with the cost information that management must have in order to make decisions between various alternative courses of action, covering

such matters as make or buy, total costs vs. unit costs, full cost vs. out-of-pocket cost, depreciation, budgeting, replacement of equipment and profit potentials. The second paper, which was presented at the recent International Management Conference in Sweden, gives a historical summary of cost accounting developments and a statement of the problems now facing industrial accountants. The third article, which is illustrated with flow charts and job analysis schedules, gives a fairly simple method of costing for clerical functions which might be of value in controlling the operation of large clerical staffs performing standard routine work.

#### **Information for Directors**

"Keeping Corporate Directors Informed" is the subject of No. 24 in the Studies in Business Policy of the National Industrial Conference Board. (247 Park Avenue, N.Y.). The report is the result of a study of the methods used by the managements of over 100 companies in keeping their directors informed on financial results and other matters and it includes sample financial statements, statistical schedules, charts, and other data. The type of information supplied depends on the type of directors (employees, outsiders, etc.), the frequency of meetings, and similar variables, but it is emphasized that directors must receive sufficient information to enable them to fulfill their duties as set forth by legislation or by-laws.

#### **Administrative Organization and Control**

The 16th August issue of "The Accountant" contains the first section of a paper by Kenneth J. Wharton on the above subject, which is continued in the subsequent two issues. Mr. Wharton is concerned with the lack of incentive for increasing efficiency and developing new methods of administrative organization and control. Improvements in factory techniques are adopted quickly because of the spur of competition, but unless managers have the personal energy or time to study their organizations continuously, the clerical end of business inevitably becomes more and more inefficient. The paper is intended to set forth the theories of organization and the best methods of administration.

#### **Social Accounting**

The application of double entry accounting techniques to the economic transactions of a nation as a whole is the



subject of two absorbing articles by F. Sewell Bray in the 30th August and 6th September issues of "The Accountant". Mr. Bray has long been noted for his invaluable contributions to the thinking regarding the economic implications of financial accounting and he now calls on accountants to record and publicize the results of everyday life of society as a whole in order that Governments can have the data necessary for taking social policy decisions. Mr. Bray has succeeded in handling a vast subject in a manner which is readily understandable and interesting to all.

#### **Statement on Inventory Reserves**

The Committee on accounting procedure of the American Institute has under discussion the problem of inventory reserves and it has released in the September "Journal of Accountancy" a statement on the deliberations to date. The Committee is gravely concerned over the possible manipulation of yearly profits by the provision or reversal of such reserves and points out that the LIFO inventory valuation basis meets the requirements for which reserves are demanded, while at the same time guaranteeing some degree of consistency in the accounts. The Committee recognizes that management is concerned over the profit inflation resulting from high prices and that it feels that such profits are not true profits, but will be offset by future losses when prices drop. Nevertheless, the Committee argues that management must report what profits are and not what management would like them to be, and the statement concludes that inventory reserves might properly be set aside out of surplus, thus avoiding distortion of profits for the year. The views of Canadian accountants on the subject would undoubtedly be welcomed by the Committee, which will shortly issue an official statement on inventory reserves.

#### **Auditor's Investigation of Internal Control**

The steps to be taken by the external auditor in the investigation of the system of internal control employed by his client is the subject of the article by C. R. MacKlin (Price, Waterhouse & Co.) in the September "Journal of Accountancy". Under the stress of wartime emergency requirements the author feels that auditors of necessity limited investigations to a minimum during the war, and internal control and checks probably suffered also because

of the compelling emphasis on production. A healthy system of internal check and control is essential for efficient operation and the external auditor should make a thorough survey of his client's system before establishing the scope of his own audit. The author lists specific methods of undertaking such a survey.

#### **Accountant and Lawyers**

Although there is in Canada no controversy parallel to that at present raging in the U.S. between the Accounting and Legal professions regarding the "illegal practice of law", the results may well affect us at some future date. An outspoken article summing up the position to date and roundly berating both professions has been contributed by L. S. Goldberg in the September "Journal of Accountancy". Mr. Goldberg is both an accountant and a lawyer and is in a position to see both sides, but his main conclusion is that the present controversy appears to be harming both parties without producing any concrete advance towards a proper settlement.

#### **Corporate Annual Reports**

Historically, the professional accountant has taken a detached attitude towards corporate annual profits, apparently feeling free to criticize without making any particularly helpful suggestions even in the form of financial statements. This attitude is taken to task in two outstanding articles on annual reports in the September issue of "The Controller". The first, by non-accountant J. M. Surface, executive assistant to the President of Standard Oil, deals with the need for the public to understand industry's financial results, and the second, by C. E. Jarchow, Vice President and Controller of International Harvester, deals with trends in annual reports.

Dr. Surface looks on accountants as highly technical experts, but accuses too many of looking at financial statements as an end in themselves instead of merely a tool. He points out that the public generally, the Government as the executive voice of the masses, and the customer group in particular, to say nothing of the employee body, all have a very powerful voice in the future of our economic system, and that corporate annual reports should be prepared in such a way as to be informative opposite each group. Reader interest must be increased, technical language must be avoided, and if financial statements cannot be simplified,

some other way must be found to explain results to the non-accountants. Finally, he argues that these reports must be prepared mainly by accountants who are the only body of business specialists qualified to ascertain, analyze and portray the financial results of business.

According to Mr. Jarchow, the three most significant trends in annual reports are towards more complete disclosure of facts, improved reporting techniques, and towards increasing the public relations value of annual reports. Quarterly reports have been adopted by many companies, although the scope of these reports is necessarily limited because of the difficulty of measuring results accurately by short periods. Improvement in form and layout has been evident for some time and the use of illustrations, charts and tabulations has increased. Mr. Jarchow lays particular stress on the need for explaining why profits are necessary under our system and for seeing that they are not misunderstood by employees and the public. Having experienced the use of special reports for employees and other groups, he is in favour of using one report to serve all purposes.

### **Frears on Income Tax**

The importance of taxation to individuals and businesses increased tremendously during the past eight years, and it appears inevitable that we shall live with high taxes for many years. To meet an obvious need, an increasing number of text books and loose-leaf services dealing with taxation have been appearing, the latest being "Frears on Income Tax" written by Richard I. Frears and published by the Canadian Law List Publishing Company. This new book is worthy of particular notice, because of its particularly good annotations from case law, its inclusion of the main regulations issued by the Minister under the Act, and the history of the Act. Although it seems to have been designed primarily for lawyers, the book will be found of real value by accountants, who must of necessity be skilled in dealing with tax law. To be of maximum continuing value, however, the book must be followed up by annual supplements dealing with amendments to the Act, new regulations, and new case law.

## STUDENTS' DEPARTMENT

J. E. SMYTH, C.A., Editor

### NOTES AND COMMENT

No doubt it has occurred to many persons from time to time that a history of the development of bookkeeping would make modern accounting easier to understand. However this avenue of approach is obstructed by the fact that at present very little can be said with certainty about the early days of bookkeeping. On the other hand, precisely because much does remain for conjecture, there is here a stimulating opportunity for those who are willing to exercise their imagination. In this connection we are attracted by Mr. Basil Yamey's "Notes on the Origin of Double Entry Bookkeeping" which appear in the July 1947 issue of *The Accounting Review*. Mr. Yamey is Senior Lecturer in the Department of Commerce, University of Cape Town.

Mr. Yamey first makes reference to a theory which seems rather novel (to us, at any rate), that single entry *as a system* is an extension of double entry techniques (and not vice versa!). But of course if one includes all sorts of unsystematic accounting in his concept of single entry, this is not so; single entry is here thought of as a system of personal accounts only (e.g., accounts receivable and payable) which has been developed by dropping the impersonal accounts.

The article is really a brief anthology of theories concerning the origin of double entry bookkeeping. Accordingly the author cites also the arguments of an opposing school which holds that double entry is (as we had always taken for granted) an extension of single entry. It is clear that if single entry records come to include both cash and personal accounts, double entries to record remittances from customers and payments to suppliers are a foregone conclusion. One of the authorities quoted in support of this view is Professor Littleton: "Once the practice of dual entries upon opposing sides of bilateral accounts had become established, it would not be difficult to extend it by analogy to new accounts."

Even more intriguing is the author's reference to the theory that double entry may have been nurtured in agency accounts. The basis for this argument is that agents, to

be accountable to their principals, would have one of the earliest incentives for keeping systematic records. The agent must continually keep in mind his accountability to his principal, and in addition he will likely maintain a detailed record of his transactions. This means that the agent would learn to use an account in the name of his principal side by side with a cash account (and accounts receivable), and once again we may be looking at double entry in the embryo stage, for a transaction which affects one account must affect the other. "Every expense or item of revenue whether in cash or on credit decreases or increases the debt due to the principal and also necessitates an entry in the cash account or a personal account. Hence one of the formal characteristics of double entry may have existed in the earliest systems of agency accounting."

From here it is an easy enough step to adopt agency accounting to the requirements of the business proper, the principal's account becoming by analogy a proprietorship account in the transition. When supplemented with the ingenious observation that many agents may have also acted as bookkeepers for their principals, the possibility of this generalization of agency accounting techniques seems further substantiated.

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### **TIMETABLE OF EXAMINATIONS**

The morning sessions will be from 9 a.m. to 1 p.m., and afternoon sessions from 2 to 6 o'clock.

#### **Monday, December 1**

Morning session—Final Auditing I.  
Afternoon session—Intermediate Auditing I.

#### **Tuesday, December 2**

Morning session—Final Auditing II.  
Afternoon session—Intermediate Auditing II.

#### **Wednesday, December 3**

Morning session—Final Accounting I.  
Afternoon session—Intermediate Accounting I.

#### **Thursday, December 4**

Morning session—Final Accounting II.  
Afternoon session—Intermediate Accounting II.

#### **Friday, December 5**

Morning session—Final Accounting III.

#### **Saturday, December 6**

Morning session—Final Accounting IV.

## PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

## PROBLEM I

## INTERMEDIATE EXAMINATION, DECEMBER 1946

## Accounting II, Question 2 (40 marks)

A shareholder of the Alpha Company Limited incorporated under the Dominion Companies Act complains that the following balance sheet as of 30th September 1946 and income account for the year ended on that date, which had been presented to the annual meeting as certified by the auditor, do not provide him with all the information to which he believes he is entitled.

## ASSETS

Cash .....	\$ 250,000
Investments .....	652,500
Receivables .....	242,850
Inventories .....	281,200
Prepaid expenses .....	106,975
Land .....	50,000
Buildings .....	625,000
Machinery .....	1,258,000
Furniture .....	15,700
	<u>\$3,482,225</u>

## LIABILITIES

Accounts payable .....	\$ 161,000
Bonds payable .....	450,000
Capital and surplus .....	2,556,225
Reserves .....	315,000
	<u>\$3,482,225</u>

## CONDENSED INCOME AND SURPLUS ACCOUNT

Balance 1st October 1945 .....	\$ 884,600
Add profit for year .....	295,625
	<u>\$1,180,225</u>
Deduct dividends paid on preference shares during year .....	24,000

Balance 30th September 1946 .....	\$1,156,225
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As a result of his complaint, the following information is furnished by the accountant of the company:

## 1. Investments consist of:

3% Victory bonds purchased at par and with a market price of 105, which are held by the bank as collateral for advances .....	\$ 200,000
Accrued interest at 30th September 1946 on Victory bonds .....	2,500
Purchase price of all the outstanding shares of the Beta Company Limited .....	125,000
Post-war refund of taxes in prior years .....	325,000
	<u>\$ 652,500</u>

# THE CANADIAN CHARTERED ACCOUNTANT

2. Receivables consist of:	
Drafts lodged with the bank for collection .....	\$ 40,000
Trade accounts receivable .....	180,000
Travel advances to employees .....	2,050
Advance to the Managing Director .....	1,000
Advance to the Beta Company Limited to finance construction of new building .....	19,800
	<u>\$ 242,850</u>
3. Inventories have been taken by actual weight or count and consist of:	
Raw materials valued at lower of cost or market .....	\$ 150,000
Work in process valued at direct labor and material costs expended plus applicable proportion of overhead .....	37,000
Finished goods valued at selling price less 30% .....	94,200
	<u>\$ 281,200</u>
4. Prepaid expenses consist of:	
The unabsorbed portion of organization expenses ..	\$ 14,975
Unexpired insurance and Workmen's compensation .....	10,000
Experimental and development work in connection with future production .....	25,000
Payments made on account of current year's income taxes .....	57,000
	<u>\$ 106,975</u>
5. Accounts payable consist of:	
Trade accounts payable and accrued .....	\$ 69,000
Bank loan .....	92,000
	<u>\$ 161,000</u>
6. The bonds payable bear 3 per cent interest, payable half yearly and are secured by a first mortgage on all real estate and property of the company by a trust deed dated 31st October 1942. They are repayable as follows:	
On 31st October 1946 .....	\$ 75,000
On 31st October 1947 .....	75,000
On 31st October 1948 .....	150,000
On 31st October 1949 .....	150,000
	<u>\$ 450,000</u>
7. The authorized capital stock of the company consists of:	
100,000 6% cumulative redeemable preference shares having a par value of \$10 each.	
1,000,000 common shares having no par value.	
55,000 preference shares were issued at time of organization in 1942 and 5,000 of these shares were redeemed during the current year.	
900,000 common shares were also issued in 1942 at which time the directors fixed the consideration at \$1 per share and	



## STUDENTS' DEPARTMENT

provided that the maximum amount allowed by the governing act be set aside as a distributable surplus. No entry has been made on the books regarding this decision.

8. In recording the depreciated replacement values of fixed assets on the books as determined by the Delta Appraisal Co. Ltd. on 30th December 1942 a surplus of \$300,000 over the then net book values was credited to surplus account. Subsequent additions have been recorded at cost.
9. The last quarterly dividend for the fiscal year on the preferred stock has been declared and is payable 1st November 1946 but has not been set up in the accounts.
10. Reserves consist of:
 

Bad debts from trade accounts receivable .....	\$ 10,000
Depreciation on fixed assets .....	305,000
	\$ 315,000
11. Provision has not been made for income and excess profits taxes on current year's income. It is estimated that they will amount to \$167,000 of which nothing is refundable.
12. The following items have been provided for in determining the income for the year:
 

Income earned on investments including \$5,000 dividend received from subsidiary .....	\$ 12,500
Gain on sale of securities .....	\$ 4,200
Depreciation on fixed assets .....	102,500
Written off organization expense .....	5,000
Interest paid on bonds less accrued 1st October 1945 .....	7,875
Administrative expenses including executive salaries \$37,000, Directors' fees \$1,600, Legal fees \$2,400	96,000
13. The management does not wish any adjustment made for the \$16,000 profit earned by Beta Co. during year.

### Required:

- (a) Revised balance sheet and income and surplus accounts prepared in conformity with good accounting practice and the requirements of the Dominion Companies Act.
- (b) Indicate any items shown separately in your solution that are not so required by the act.

### SOLUTION

1. Calculation of liability for income taxes:
 

Liability as stated .....	\$ 167,000
Deduct payments on account .....	57,000
	\$ 110,000
2. Calculation of accrued interest on bonds payable and interest expense:
 

Par value outstanding since last interest date, April 30, 1946 — \$450,000	
5/12 of 3% of \$450,000 =	5,625
and shown in income account	7,875
Expense for year 3% on \$450,000	\$13,500

# THE CANADIAN CHARTERED ACCOUNTANT

3. Calculation of accrued dividend and total dividends for year:		
1/4 of 6% of 50,000 x \$10.00 =	7,500	
Add already paid	24,000	
Total for year	\$	31,500
4. Calculation of Earned Surplus balance at October 1, 1945:		
Balance shown in question .....	\$	884,600
Deduct Appraisal Surplus .....		300,000
Balance October 1, 1945 .....	\$	584,600
5. Calculation of correct net profits for year:		
Write off of organization expense charged to operations .....	5,000	
Profit as shown in question .....	295,625	300,625
Deduct:		
Provision for Income Taxes .....	167,000	
Accrued interest on bonds .....	5,625	
Gain on sale of investments credited income .....	4,200	176,825
	\$	123,800
6. Calculation of Distributable Surplus		
25% of 900,000 shares at \$1.00 =	\$	225,000

## THE ALPHA COMPANY LIMITED

### BALANCE SHEET

September 30, 1946

#### ASSETS

Current Assets:		
Cash on hand and in bank .....	\$	250,000
Dominion of Canada 3% bonds at cost and accrued interest (market value \$212,500) ..		202,500
Bills receivable .....	\$	40,000
Accounts Receivable .	\$	180,000
Less Reserve for bad debts .....	10,000	170,000
*Employees advances .....	2,050	
Advance to director .....	1,000	213,050
Inventories, as determined by the management and valued on the basis of estimated cost for finished and in process goods and the lower of cost or market for raw materials:		
Raw Materials .....	150,000	
Work in Process .....	37,000	
Finished Goods .....	94,200	281,200
Prepaid Expenses .....	10,000	956,750

# STUDENTS' DEPARTMENT

Refundable portion of excess profits taxes ..			325,000
Investments in and advances to subsidiary:			
Shares in subsidiary company at cost ....	125,000		
Advances to subsidiary .....	19,800		144,800
Fixed assets—at depreciated replacement values as determined by the Delta Appraisal Co. Ltd. on December 30, 1942 with subsequent additions at cost:			
Land .....	50,000		
Buildings .....	625,000		
Machinery and equipment .....	1,258,000		
Furniture and fixtures .....	15,700		
	1,898,700		
Less Reserve for depreciation .	305,000	1,593,700	1,643,700
Deferred Charges:			
Organization Expense less amounts written off	14,975		
Development expenditures chargeable to future operations .....	25,000		39,975
			<u>\$3,110,225</u>

## LIABILITIES

Current Liabilities:			
Bank loan (secured) .....	\$ 92,000		
Accounts payable and accrued expenses ....	69,000		
Provision for federal taxes on income .....	110,000		
First mortgage serial bonds due October 31, 1946 .....	75,000		
*Accrued interest on bonds .....	5,625		
Dividend on preference shares payable November 1, 1946 .....	7,500	\$ 359,125	
First mortgage serial 3% bonds:			
Due October 31, 1947 .....	75,000		
Due October 31, 1948 .....	150,000		
Due October 31, 1949 .....	150,000		375,000
Total liabilities .....			734,125
Capital and Surplus:			
Capital stock:			
*Authorized:			
100,000 cumulative redeemable 6% preference shares par value \$10.00 each:			
1,000,000 common shares of no par value:			
Issued and fully paid:			
55,000 preference shares .	550,000		
Less			
5,000 preference shares redeemed .....	50,000	500,000	
900,000 common shares .....		675,000	
			<u>1,175,000</u>

**THE CANADIAN CHARTERED ACCOUNTANT**

Capital surplus from redemption of preference shares .....	50,000	
Distributable surplus .....	225,000	
Earned surplus .....	626,100	
Appraisal surplus .....	300,000	2,376,100
		<u>\$3,110,225</u>

NOTE: The profits of subsidiary are not reflected in the accounts of the Alpha Co. Ltd. except for dividends received which were not in excess of profits earned.

\*Not required by law to be shown separately.

**THE ALPHA COMPANY LIMITED**

**CONDENSED INCOME ACCOUNT**

For the year ended September 30, 1946

Net Profit for the year before providing for the undernoted items .....(1)....	\$435,300.
Income from investments .....	12,500.
	<u>447,800.</u>
Depreciation of plant and equipment .....	\$102,500.
Interest on bonds .....	13,500.
Executive salaries .....	37,000.
Directors' fees .....	1,600.
Legal fees .....	2,400.
	<u>157,000.</u>
Net Profit before provision for federal taxes on income .....	290,800.
Provision for federal taxes on income .....	167,000.
Net profit for year transferred to earned surplus .....	<u>\$123,800.</u>

**EARNED SURPLUS ACCOUNT**

For the year ended September 30, 1946

Balance at credit, September 30, 1945 .....	\$584,600.
Add:	
Net profit for year .....	\$123,800.
Gain on sale of investments .....(2)....	4,200.
	<u>712,600.</u>
Deduct:	
Amount written off organization expenses (2) .....	5,000.
Dividends paid on preference shares .....	31,500.
Appropriation on redemption of 5,000 preference shares .....	50,000.
	<u>86,500.</u>
Balance at credit, September 30, 1946 .....	<u>\$626,100.</u>

(1) Obtained by calculation from net profit backward

(2) Alternatively these items may be placed in income account

# STUDENTS' DEPARTMENT

## PROBLEM II

FINAL EXAMINATION, DECEMBER 1946

Accounting III, Question 3 (25 marks)

Mr. W. O. Isme died on 1st April 1946 and the executor has asked you to prepare the necessary statements as at 30th September 1946 for submission to the beneficiaries. Under the will the widow has the free use of the family residence and is to receive half of the net revenue during her lifetime, the remainder being divided equally between two sons. Upon the death of the widow the whole estate goes to the sons in equal shares.

The assets and liabilities of the estate at 1st April 1946 were as follows:

<i>Assets</i>	
Bank .....	\$ 12,000
Family residence .....	20,000
Household effects .....	5,000
Life insurance .....	75,000
Dominion of Canada 3% Bonds (Int. 1st May and Nov.) ..	50,000
Real estate (rented properties) .....	30,000
Mortgages .....	10,000
Value of $\frac{1}{2}$ interest in partnership Brown & Isme .....	40,000
Shares in Industrial Coys. ....	80,000
	<u>\$250,000</u>

<i>Liabilities</i>	
Income tax to date of death (estimated) .....	\$ 2,500
Taxes on family residence 1946 .....	300
Sundry accounts payable .....	400
	<u>\$ 3,200</u>

The following transactions took place from 1st April 1946 to 30th September 1946:

<i>Receipts</i>	
Interest on Dominion of Canada Bonds .....	\$ 750
Interest on mortgage $\frac{1}{2}$ year 1st June at 6% per annum ..	210
Dividend on shares in industrial Coys. quarter ending 30th June .....	80
Rentals from properties May to September .....	1,200
Sale of foreclosed property .....	1,500
Sale of interest in partnership .....	50,000
Sale of shares in industrial coys. (total holdings) .....	9,000
Life insurance .....	75,000

<i>Payments</i>	
Succession duty .....	\$ 12,000
Funeral expenses .....	1,000
Taxes on family residence .....	300
Sundry accounts payable .....	400
Expenses on rented properties .....	100
Expenses re foreclosed property .....	150
Income tax .....	2,500
Payments to widow .....	900
Payments to sons .....	300
Dominion of Canada 3% Bonds .....	120,000

The foreclosed property represented a mortgage of \$2,000 with interest in arrears \$240 (2 years) at date of death. Sale was made at 30th September 1946.

Sale of interest in partnership included \$8,400 being share of profits for year ended 30th April 1946.

# THE CANADIAN CHARTERED ACCOUNTANT

## Required:

- (a) Statement of executor's cash transactions.
  - (b) Statement of:
    1. Capital account.
    2. Revenue account.
  - (c) Balance sheet as at 30th September 1946.
- All calculations to nearest dollar.

## SOLUTION

Estate of W. O. Isme  
Statement of executor's cash transactions  
From 1st April to 30th September 1946

<i>Receipts</i>			
	<i>Capital</i>	<i>Revenue</i>	<i>Total</i>
Cash in bank 1st April, 1946 .....	\$ 12,000		\$ 12,000
Interest on D. of C. bonds .....	625	\$ 125	750
Interest on mortgage .....	140	70	210
Dividend on industrial coy. shares ....		80	80
Rentals .....		1,200	1,200
Sale of foreclosed property .....	1,460	40	1,500
Sale of partnership interest .....	49,300	700	50,000
Sale of industrial coy. shares .....	9,000		9,000
Life insurance .....	75,000		75,000
	<u>\$147,525</u>	<u>\$ 2,215</u>	<u>\$149,740</u>

<i>Disbursements</i>			
	<i>Capital</i>	<i>Revenue</i>	<i>Total</i>
Succession duty .....	\$ 12,000		\$ 12,000
Funeral expenses .....	1,000		1,000
Taxes on family residence .....	300		300
Sundry accounts payable .....	400		400
Expenses on rented properties .....		\$ 100	100
Expenses re foreclosed property .....	150		150
Income tax .....	2,500		2,500
Advance to widow .....		900	900
Advance to sons .....		300	300
Dominion of Canada bonds .....	120,000		120,000
	<u>\$136,350</u>	<u>\$ 1,300</u>	<u>\$137,650</u>
Balance in bank 30th September, 1946..	11,175	915	12,090
	<u>\$147,525</u>	<u>\$ 2,215</u>	<u>\$149,740</u>

<i>Capital Account</i>		
	<i>Dr.</i>	<i>Cr.</i>
Balance 1st April, 1946 .....		\$246,800
Interest on D. of C. bonds .....		625
Interest on mortgage .....		140
Profit on sale of partnership .....		9,300
Profit on sale of industrial coy. shares .....		1,000
Loss on mortgage and expenses .....	\$ 690	
Succession duty .....	12,000	
Funeral expenses .....	1,000	
Balance 30th September, 1946 .....	244,175	
	<u>\$257,865</u>	<u>\$257,865</u>

# STUDENTS' DEPARTMENT

	Dr.	Cr.
<i>Revenue Account</i>		
Interest on D. of C. bonds .....		\$ 125
Interest on mortgages .....		110
Dividend on industrial coy. shares .....		80
Rentals .....		1,200
Partnership profits .....		700
Expenses on rented properties .....	\$ 100	
Balance 30th September, 1946 .....	2,115	
	<u>\$ 2,215</u>	<u>\$ 2,215</u>

Balance distributable	
To widow .....	\$ 1,057
To sons .....	1,058
	<u>\$ 2,115</u>

<i>Widow</i>	
Share of revenue .....	\$ 1,057
Less Payments on account .....	900
Balance due .....	<u>\$ 157</u>

<i>Sons</i>	
Share of revenue .....	\$ 1,058
Less Payment on account .....	300
Balance due .....	<u>\$ 758</u>

## BALANCE SHEET as at September 30, 1946

<i>Assets</i>		
Cash in bank capital account .....	\$ 11,175	
revenue account .....	915	\$ 12,090
Dominion of Canada bonds .....		170,000
Mortgages .....		8,000
Real estate .....		30,000
Family residence .....	\$ 20,000	
Household effects .....	5,000	25,000
		<u>\$245,090</u>

<i>Liabilities</i>		
Capital account .....		\$244,175
Due to widow .....	\$ 157	
Due to sons .....	758	915
		<u>\$245,090</u>

*Editor's note:* The above solution is in accordance with the practice in most Canadian provinces but a longer solution based on the Scottish system of charge and discharge would be relevant for students in those provinces where that method is applicable.



PROBLEM III  
FINAL EXAMINATIONS, DECEMBER 1946

Auditing II, Question 3 (15 marks)

As auditor you are required to examine and report on the statements of a parent company. Discuss your attitude and procedure with respect to the following items alternately if the statements are consolidated and not consolidated.

- (a) The loss in one subsidiary exceeds the profits in the others and the directors wish no mention made of the fact.
- (b) A subsidiary is committed to heavy capital expenditure, for which the parent company will need to furnish the funds.
- (c) A subsidiary would have shown considerable loss except for unusual credits given by the parent company and included in the latter's expenses.
- (d) The parent company has guaranteed a large instalment purchase contract of a subsidiary.

SOLUTION

(a) If the statements are consolidated, the parent company's share of the net loss would be taken up in the profit and loss account, and no comment is necessary.

If not consolidated, and assuming that it is a Dominion incorporation, the Dominion Companies Act requires that the auditor report generally how profits and losses of subsidiaries have been dealt with in the holding company's accounts, and in addition, if the aggregate of losses over profits of subsidiaries have not been provided for in the holding company's accounts, the amount by which, in the auditors opinion, the profit and loss and surplus of the holding company should be reduced to provide for its share of that loss.

If the incorporation is under another Act and there is no such requirement in that Act, it would still seem necessary, or at least highly desirable either to provide for the loss or to report on it as the accounts otherwise would not reveal a true statement of the result of operations for the year.

(b) If consolidated, a footnote should indicate this outstanding commitment.

If not consolidated; this is not a direct obligation of the parent company—presumably—and it may be that only a possibly difficult or abnormal situation in prospect would call for present reference by the company or its auditors. It would be most appropriate, however, to have this matter referred to in the Directors' Report.

(c) If consolidated, the inter-company credits and charges would not affect the results shown. If not consolidated, the auditor would be concerned about the admissibility of the charges in respect to the parent company's tax liability. Presumably these are non-recurring charges, and perhaps some suitable notation in the profit and loss account as to inclusion of non-recurring charges to expenses before determining profits would be sufficient. The relative importance of the amount is a factor, of course. If the subsidiary still shows a loss after these credits which is not covered by profits of other subsidiaries see answer to (a).

(d) If the accounts are consolidated, the procedure would depend on whether the liability had been taken up in the books of the subsidiary or not. If it has been the liability will appear on the consolidated balance sheet; if not, a footnote should show the contingent liability, stating its nature and amount.

If the accounts are not consolidated, a footnote showing the contingent liability should appear on the balance sheet.